KPMG
10 Customhouse Quay
PO Box 996
Wellington 6140
New Zealand
T: +64 4 816 4500

Our ref: TWG Capital and Wealth Submission.docx

The Chair
The Tax Working Group
By email:
submissions@taxworkinggroup.govt.nz

5 November 2018

Dear Sir

**KPMG's feedback on Chapter 6 and Appendix B of the Tax Working Group's Interim Report**

As outlined in our 12 October submission on the Tax Working Group's (the "Group's Interim") Interim Report, we provide our comments on *Chapter 6 – Capital and Wealth* and *Appendix B – Design Features for extending the taxation of capital gains*.

We recognise that the Group is having to consider feedback from a variety of different stakeholders and is time constrained in its deliberations, given the need to report to Government with final recommendations by no later than February 2019. Our feedback on extending the taxation of capital income (and some of the detailed design features therein) is therefore more concise than it might otherwise be.

We note that "capital gains tax" is used as short-hand for "extending the taxation of capital income" or "taxing more capital gains". We have used these terms interchangeably in our submission.

We would obviously be happy to expand on these comments if more detail or background is required.

## General comments

In our submission on the March Submissions Background Paper, we noted that the Group's task was like "doing a jigsaw puzzle with pieces that don't fit, or like poking at jelly, pushing in one spot makes another stick out". We noted that as tax policy development involves trade-offs and judgements, it was critical that these are transparent.

We believe this is particularly relevant to the issue of taxing capital income/gains. We fully expect there will be a spectrum of responses. While it will be challenging for the Group to work through these perspectives, we strongly recommend that the Final Report clearly state the responses to the issues raised.

The fairness arguments in favour of extending the taxation of capital gains to assets and property that are currently not within the tax net are clear. What is less clear, when working through the design issues (and the compromises required to make the rules workable), is whether the benefits outweigh the costs. Therefore, we reiterate the need for the Group to clearly articulate the support for its conclusions, whatever the final recommendations may be.

We further acknowledge that, given a revenue neutral package is required, any limitations on what capital gains are included will impact the Group's ability to make other revenue negative recommendations. The trade-offs for this should also be made clear.

## The specific design questions we have considered

### What additional capital gains should be taxed?

We see the fairness problem with capital gains as due to the ability to convert otherwise taxable "income" gains to non-taxable "capital" gains.

The Interim Report notes that some property and assets are already subject to tax (e.g. under the financial arrangements and land rules or the Fair Dividend Rate) and does not propose to change this existing treatment. (However, see below for the opportunity to simplify some of these rules, which a capital gains tax would allow.)

Therefore, the assets under consideration are New Zealand shares, certain Australian listed shares (currently excluded from the Foreign Investment Fund Rules) and real property (other than the family home or the land below it), to the extent not revenue account property already.

The Group considers that certain personal assets (such as cars, boats, art and jewellery) should remain outside the base. We support this from a principled perspective as there is little opportunity to convert otherwise taxable income to capital gains from these assets. Further, from a pragmatic perspective, we note the experience in other countries where no distinction is made (e.g. Australia). The inclusion of certain personal assets has created significant complexity in its capital gains tax rules.

However, consistent with our definition of the problem, second homes or holiday homes, which are also private assets, should not be within scope[1]. The argument for their inclusion, that these assets appreciate, is not principled. Particularly, as any losses would be treated as private and disallowed, this would create a one-way "bet" in favour of the Crown[2]. This will be perceived as inequitable. (We note that one of the challenges for the Group is to identify a package that is both fiscally and publicly acceptable. Inclusion of second homes and family homes, in our view, risk damaging the latter.)

We believe a better delineation is between assets that are "income" assets (that is, where a more than incidental purpose is to hold to derive income or a capital gain) and "private" assets (where the purpose is to hold primarily for private consumption/enjoyment). Under such a test, second and holiday homes would be correctly classified as private assets and therefore excluded.

### When should the tax be collected?

The Interim Report notes that the two options: realisation and accruals basis taxation raise different issues. In our view, a realisations basis appears the most practical approach[3] in most cases, due to the alignment with cash flow to pay the tax. While an accruals basis would mitigate the issue of "lock in" effects, we do not believe it would be perceived as fair, and is therefore unlikely to be sustainable.

---

[1] For completeness, when we refer to second homes, this in intended to encompass arrangements where a person may work and live in different locations (e.g. their family is in Auckland, but they work in Wellington). Similarly, for holiday homes, we mean those properties which are only privately used (i.e. are not mixed-use assets).

[2] Further, while second and holiday homes (and the underlying land) may nominally increase in value, economically, the investor may not make a gain once financing and other costs are taken into account. As it is proposed that these holding and maintenance costs would not receive any tax recognition, this potentially over-taxes these assets economically. This is likely to be perceived as unfair.

[3] Certain investments of managed funds (PIEs) is a possible exception, due to their operation requirements and also the ability to manage cash-flow constraints to pay the tax. We comment on this separately.

*What constitutes a realisation event?*

We agree that a realisation basis should apply when the asset is actually realised (i.e. sale or destruction or irreparable damage) and for certain deemed events (such as when the asset leaves the tax base – e.g. if there is change of tax residence of the holder or in the case of certain transfers, subject to appropriate rollover reliefs – see below).

*Rollover relief*

We notice that the Interim Report notes that the principles underlying rollover relief should be limited to situations where there has been no change of ownership in substance (such as intra-group transactions or corporate re-organisations where there is no change in economic ownership) or where the gain cannot be said to have "come home to the vendor". We agree with these general principles.

We make the following observations:

— The issue of rollover relief on death needs to be considered carefully. It is not clear to us whether a realisation event on death would be equivalent to an inheritance tax, which is outside the Group's terms of reference. If considered an inheritance tax, it does pose the question of when such transfers can be taxed (if at all). We agree that a wider family unit concept needs to be considered if rollover relief is provided on death, given the complexity of modern familial and relationship arrangements.

— We also consider that any rollover relief for settling assets on trust needs to balance the role of trusts in New Zealand for family planning and succession planning purposes (which we believe are within scope of rollover relief, particularly given current reliefs afforded for relationship property transfers) and the risk trusts may pose to the transfer of assets without tax consequences.

— Lack of rollover relief for disposition of business assets (land/premises, plant and equipment), where the proceeds are reinvested, has the potential to create significant economic costs (if the replacement asset has to be acquired in the same market). Again, a balance needs to be struck between minimising investment distortions and ensuring there is a revenue base from taxing capital gains.

**How to tax**

We agree with the Interim Report's conclusion that tax should be levied on the full gain (under the capital gains tax option) at marginal tax rates, to maintain simplicity and to integrate with existing rules.

*Opportunities should be taken to simplify the current income tax rules*

Our willingness to consider a capital gains tax is due to the fairness problem, but also the opportunity that it would provide to simplify our current income tax rules. We note, in particular, that this should allow rationalisation of a number of existing provisions, such as the current land tax rules in sub-part CB of the Income Tax Act.

The current rules are often complex to prevent capital/revenue arguments or to prevent perceived re-characterisations of income as capital gains. As well as the land tax rules, the employee share scheme rules are obvious examples of complexity that would warrant a review for the ability to simplify them. These should be included in the first set of changes to be made.

We also believe that the scope of the financial arrangements rules need to be reviewed as they can currently apply to tax unrealised gains (and losses). While the "cash basis" rules provide some relief, we are aware of situations where individuals can be subject to unrealised taxation on foreign currency movements (e.g. where they own foreign real property that is mortgaged in

a foreign currency[4]). We believe there is likely to be inadvertent and significant non-compliance with the current rules, in these circumstances, which needs to be addressed.

Although we acknowledge that it may not be possible for the Group to consider all the possible changes, it should recommend that the Government's Tax Policy Work Programme should include an on-going commitment to review particular regimes for the ability to simplify them if a capital gains tax proceeds.

### Capital expenditure

We note that, although building costs and other upgrade costs would be deductible at the time of disposal if capital gains are taxed, the correct policy outcome is for building tax depreciation to be reinstated. Officials' analysis of the previous Government's 2010 tax reforms confirms that the removal of deprecation was poor policy. This would also allow other "capital expenditure" (such as seismic strengthening and leaky building remediation costs) to receive tax recognition[5].

We have commented earlier on inconsistencies in the treatment of different types of personal assets. If second and holiday homes are within scope, for example, the proposal to deny what would otherwise be considered revenue expenses (as they relate to private enjoyment) needs to be reconsidered. In particular, interest costs should be able to be capitalised to the building cost and deducted on sale, to provide a true reflection of the economic cost of owning the asset.

### Treatment of capital losses

While we recognise the "cherry-picking" (i.e. capital loss acceleration/capital gain deferral) rationale for ring-fencing capital losses, we note that the current revenue account rules do not contain any such limitations. This has the potential to create a boundary that will create complexity and the potential for disputes with Inland Revenue.

For example, a share trader is not restricted from bringing forward losses on their NZ shares (and offsetting these against their other income) while deferring the realisation of gains. If loss ring-fencing would apply to capital losses (we refer the comments at paragraph 105 of Appendix B, which suggests that portfolio listed share losses should be ring-fenced), there would be an incentive for all investors to style themselves or their investments as being held on revenue account. (Case law from the 1987 New Zealand share market crash would suggest that this may not be difficult.)

This suggests that loss ring-fencing should not proceed as a matter of general design.

We agree that if rollover relief is provided for gains, a symmetrical treatment should apply to losses. Alternatively, there should be the ability to opt out of rollover relief for both gains and losses (on entry into the rules, for existing assets, or on acquisition of a new asset that is subject to the rules).

---

[4] Often, the cash basis threshold will be exceeded as it counts both financial assets and liabilities (and NZD denominated assets and liabilities as well).
[5] We note that the classification of seismic strengthening and leaky building costs as "capital expenditure" is arguable (based on our understanding of Inland Revenue's positions).

**Transitional rules**

*Valuations*

The Interim Report suggests a "valuation day" approach is preferred with a median rule to prevent overstatement of values. We recognise the logic of this approach.

However, the challenges of requiring valuations to be sought for existing assets that are not "marketable"[6] should not be underestimated. We expect there will be significant costs in relation to valuing these assets and we are also concerned this may be subject to dispute with Inland Revenue, even if an independent valuation has been sought[7]. We note it is for these reasons that some other countries have applied taxation only to new assets.

We agree that "rule of thumb" valuation methodologies (such as rateable value or financial statement valuations) should be available as alternatives. These should emphasise that "near enough" is "good enough", to help manage compliance costs.

*Effective date – time to implement*

There is unlikely to be a long lead time to implement any new rules. (The stated dependency on the 2020 General Election result means that it is likely that a 1 April 2021 commencement date would allow less than 6 months to establish systems and processes to comply with the new rules.)

Therefore, the Group should consider a staggered implementation of any new rules. For example, the application of the new rules for PIEs, to allow for system changes, might need to be delayed by up to two years beyond the general application date.

A staggered start date, for example, may also have the advantage of relieving pressure on the ability to have valuations performed.

**Taxation of shares in foreign companies**

The Interim Report suggests that retention of the current Fair Dividend Rate ("FDR") taxation approach for portfolio (<10%) foreign shares (i.e. foreign investment fund ("FIF") interests) is preferred.

This would mean that offshore shares, in the main, would be outside the scope of any potential reform. We consider the misalignment with the taxation treatment of NZ and certain Australian listed shares could be significant, with adverse economic consequences for NZ capital markets as a result. (This is because, if NZ shares, for example, are taxed on a full realised gains basis, while offshore shares are taxed on a risk-free return rate basis, this will result in different pre- and after-tax returns for investors.)

Therefore, our preference is for consistent application of the tax rules (be that FDR or taxation of realised gains) across the same asset class, and also across different asset classes (i.e. shares and real property), where practical. We note that some concessions may be required for investment by PIEs, due to their special operational features.

The Interim Report also suggests that the FDR rate of 5% could now be too high, based on the fall in the risk-free rate. This suggests the FDR method should more readily proxy the Risk Free Return Method, if retained for offshore shares. At the time of its introduction, FDR was meant to reflect a reasonable (i.e. "fair") dividend yield, having regard to yields on NZ and Australian equities. Further, the FDR rate was set in the absence of a capital gains tax.

---

[6] Effectively, this will be any asset for which an "arm's length" valuation is not regularly published – such as most real property, shares in private companies, goodwill, etc.
[7] This is based on our experience with Inland Revenue disputing purchase price allocations.

It is less clear that the FDR method is appropriate or that the FDR rate should be reduced if there is a capital gains tax on some assets. We recognise at a "whole of economy" level that the FDR rate, appropriately set, may tax the average gains and losses. However, we are particularly concerned at the inevitable under and over taxation that will arise at the specific investor level. This will raise fairness questions and may affect the sustainability of any reform.

We consider that a detailed case for the retention of FDR for offshore shares needs to be made if a capital gains tax is recommended for NZ and certain Australian equities.

We agree that gains on shares in Controlled Foreign Companies ("CFCs") should not be taxed where the holder is a company, to integrate with the current international tax rules. This treatment should also apply to shares in non-portfolio FIFs, where the attributable FIF method is used to calculate taxable income.

### Taxation of non-residents

We agree that any extension of capital income taxation to New Zealand assets held by non-residents should be consistent with taxing rights available under New Zealand's Double Tax Agreements ("DTAs"). We note that New Zealand's DTAs generally limit domestic taxing rights to alienation of real property and, in some cases, shares in land rich companies.

### Taxation of NZ shareholders in NZ companies

We agree that the double taxation issues identified for taxing share gains will be a feature of a regime that extends capital income taxation more broadly. (We note that while this issue exists presently where investors hold their NZ shares on revenue account, it is unlikely to be widespread[8].)

Where the gain is realised at the entity level and tax paid, the availability of imputation credits (that can be attached to a taxable bonus issue or if the gain is paid out) may mitigate the double tax risk for shareholders. However, this would require the timing of investors' disposals of their shares and the realisation by the company/distribution of imputation credits to be aligned, which is unlikely to be the case – particularly for shareholdings in public (i.e. NZ listed) companies.

Therefore, double tax is a real concern and imputation does not fully address this as it is a hybrid approach rather than a full integration model.

This does raise the question of whether the correct approach is to apply capital income taxation at both shareholder and entity levels rather than, say, just the investor level (on the basis the share price should reflect entity level capital gains as well). We acknowledge the timing differences of when tax will be paid under such an approach. The trade-off is double taxation which, in our view, is arguably a greater problem.

Separately, we are concerned that while the issue of double tax is noted but not adequately resolved, specific rules are proposed to address perceived "double deduction" (loss) issues, such as adjusting the cost base of shareholdings. This, again, appears to reflect a disproportionate emphasis on tax base maintenance. It will result in perceptions of unfairness and therefore affect the sustainability of the reform.

We recommend that the availability of the look through company ("LTC") rules be extended by easing the entry requirements to access these rules. This should ensure that for a greater number of private companies, the issue of double taxation can be more appropriately mitigated.

[8] For double taxation to currently arise, both the investor and the company have to be on revenue account.

**Taxation of managed investment entities**

We consider the features of the Portfolio Investment Entity ("PIE") regime require special consideration.

We note the objective of the PIE regime is to, broadly speaking, tax investors' savings through a PIE as if they were direct investments, without imposing tax compliance obligations on the investors. The current tax policy settings for both multi-rate PIEs ("MRPs") and listed PIEs reflect this. We strongly urge the design of any potential capital income extension to keep this objective in mind.

We make the following observations:

— In principle, we do not support a specific exemption for gains on New Zealand and Australian listed shares for KiwiSaver MRPs. (The current exemption for PIEs is based on such gains not generally being taxed if investors invest directly, which would cease to be the case under an extension of capital income taxation.) In our view, this risks tax creating investment distortions (vis-à-vis direct and non-KiwiSaver PIE investment). We believe the question of whether the tax settings for locked-in retirement savings, such as KiwiSaver, is appropriate should be considered separately.

— Where a MRP holds shares, taxing gains on a realised basis is likely to be difficult due to the requirement for taxable income, in most cases, to be calculated daily and taxed to investors annually and on exit (or quarterly)[9]. The extension of FDR to New Zealand and Australian listed share investments by MRPs appears to be the simplest option (as this treatment applies to MRP's offshore shares, excluding certain Australian listed investments, presently). Alternatively, taxing unrealised gains would also appear to be workable and may be preferred across all share investments of an MRP as it would tax actual returns while losses would be "cashed out"[10]. However, consideration would need to be given to whether this will over-tax. We agree that investor redemptions of units in MRPs should not be a separate taxing event (as there is no need as capital income/(losses) will be attributable and taxed to investors by the MRP.

— Unlike shares, property assets will be significantly less liquid. Therefore, an unrealised basis of taxation (either FDR or taxing unrealised gains) is unlikely to be feasible. Further, a realised basis of taxation will create investor equity issues for property owning MRPs. This suggests to us that for both MRPs and listed PIEs holding predominantly real property assets, the only workable option appears to be taxation at the investor level (i.e. when investors sell or redeem their interests in the PIE), and not the entity level. Having tax deducted/paid by the MRP or listed PIE would result in the double tax. This would be contrary to the principle of taxing an investor in a PIE broadly the same as if that investor held the underlying asset directly.

**Administrative aspects**

The administrative aspects highlight to us some of the main workability issues with taxing more capital gains:

— We agree a withholding tax is not feasible for the reasons outlined in the Interim Report. Therefore, Inland Revenue will need to monitor compliance. We note that one of the

[9] This is to allow MRPs to effectively manage investor equity, as in the absence of accrual taxation, some investors may avoid taxation liabilities altogether, while others may bear the full tax impost (i.e. as the "last man standing").
[10] We understand that this may be more easily explainable to investors. It would also address current tax difficulties in hedging offshore shares under FDR.

criticisms is that Inland Revenue does not appropriately enforce the current rules. While a capital gains tax should remove any uncertainty around taxability of gains, it will still require a degree of "presence" by Inland Revenue to demonstrate integrity of the rules.

— In a tax year where a capital gain is realised, a taxpayer may face a significant increase in their effective marginal tax rate (including having to factor this into their provisional tax obligations for the year). A spreading mechanism (say, over the year of sale and the subsequent two years) should be considered, if the full gain will be taxed.

— The requirement to provide itemised information on capital assets to Inland Revenue annually will substantially add to compliance costs. *Business Transformation* will result in most individuals having to interact with Inland Revenue. However, its aim is to simplify this process by Inland Revenue pre- income information in tax returns. This will not be possible as capital gains will be "other income" (i.e. there will generally not be third party reporting on these gains). It is likely there will be compliance issues with, particularly, long-held assets. A realisation, and therefore taxable income, may not occur for many years. Given the potential for Inland Revenue to dispute a "day one" valuation for existing assets, at the time of sale, a process to give taxpayers comfort on their valuations should be legislated so as to reduce the potential for dispute. Alternatively, the four year time bar should apply to valuations in the transition year. This should ensure the Commissioner is appropriately incentivised to challenge valuations within a reasonable time frame.

## Further information

Please contact me on 04 816 4518 if you require further clarification on this or our other submissions.

Yours sincerely

**John F Cantin**
Partner