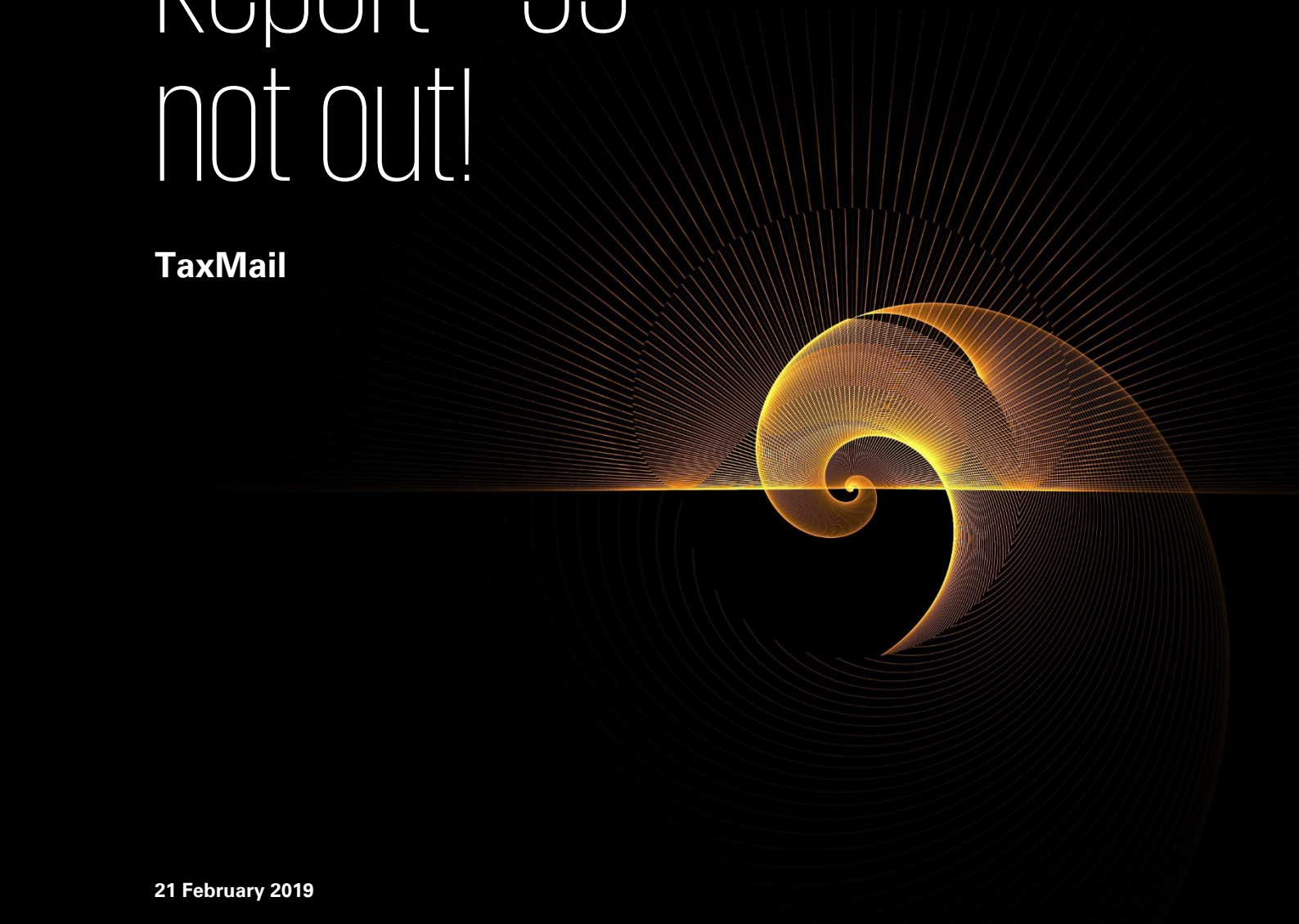
Tax Working Group Final Report – 99 not out!

TaxMail



21 February 2019

kpmg.com/nz/tax

Key Tax Working Group (TWG) recommendations

The Final Report runs to many hundreds of pages of analysis. Taxmail highlights what we consider are the TWG's key recommendations and relevant design features from an initial review. As the political process proceeds, much of the detail will be also be relevant. We therefore encourage a thorough review of the reports.

Illustrative revenue neutral packages

The TWG has provided four illustrative packages that it considers could improve the structure, fairness and balance of the tax system. These packages contain a range of tax reductions that would use tax collected from other recommendations, primarily a capital gains tax (CGT):

Package 1: Increasing progressivity

1. **Personal tax**

   Increasing the bottom income tax threshold of $14,000, from 1 April 2022, to:

   - $22,500 *[A tax cut of up to $595]; or*
   - $30,000 with an increase in the second marginal rate from 17.5% to 21%. *[A tax cut of up to $1,120 for those on incomes up to $30k, between $490 and $1,120 for incomes between $30k and $48k, and $490 for incomes more than $48k]*

2. **Retirement savings** (primarily aimed at those on lower incomes):

   - Reducing the bottom and middle KiwiSaver PIE tax rates from 10.5% and 17.5% to 5.5% and 12.5%.
   - Refunding/exempting Employer Superannuation Contribution Tax on KiwiSaver contributions for those on incomes of up to $48,000.
   - Access to the full member tax credit for the primary caregiver during maternity leave (regardless of their contributions to KiwiSaver).

3. **Seismic Strengthening**

   Allowing depreciation over 30 years for seismic strengthening of buildings to 67% of the new building standard.

Package 2: Business and housing affordability focus

1. **Personal Tax**

   Increasing the bottom income tax threshold to $20,000 from 1 April 2023. *[A tax cut of up to $420]*

2. **Retirement savings** same as Package 1

3. **Building and business tax** including:

   - Restoring building tax depreciation for commercial, industrial and multi-unit residential buildings (at a 1% diminishing value rate).
   - Deductibility for business "black hole" expenditure over 5 years.
   - Removing tax loss continuity restrictions for start-ups.
   - Removing rental loss ring-fencing.

Package 3: Savings focus

1. **Personal Tax**

   Increasing the bottom income tax threshold to $20,000 from 1 April 2023. *[A tax cut of up to $420]*
2. **Retirement savings** same as Package 1 plus:
   - Increasing the KiwiSaver member tax credit from $0.5 to $0.75 per dollar of contribution (up to the $1,024 contribution cap).
   - Abating the Employer Superannuation Contribution Tax exemption at 6% for incomes above $48,000 (no exemption for those earning more than $70,000).
3. **Seismic strengthening** same as Package 1.

Package 4: Diversified focus

1. **Personal Tax**

   Increasing the bottom income tax threshold to $20,000 from 1 April 2023. *[A tax cut of up to $420]*
2. **Retirement savings** same as Package 3 without an increase in the KiwiSaver member tax credit.
3. **Building and business tax** same as Package 2, but with application delayed to 2023/24.

Each package will reduce tax by $8 billion over five years (the amount estimated to be raised by a CGT). The difference is how that benefit is spread between individuals, business and savers.

Our thoughts on the packages

The last time a TWG report was implemented by the then Government, the focus was on a tax shift, more on consumption and property, less on income and savings. Those on lower incomes were compensated for the GST increase. This TWG, because of its CGT recommendations, provide the Government with a choice on what its focus should be.

Reactions to the packages will vary but our initial view is that Package 2 makes the most sense. As the stated reason for the CGT is to better improve the fairness of the system by taxing the same incomes at the same tax rate, it makes sense to apply the same standard to other areas of the tax system. The business measures are therefore an important part of the package. (Package 4 has a similar focus but delaying the introduction of the business measures does not itself seem fair).

Of course the packages rely on the CGT's design and application. Supporting a particular package has been positioned as necessarily supporting the CGT.

Extending taxation of capital gains

All members of the TWG support extending capital gains taxation to residential rental properties. Eight of the eleven support a wider application. The wider application is expected to raise $8 billion over five years. (This estimate is based on standard Treasury assumptions for the economy. As the Final Report notes this estimate is highly volatile).

The majority's judgement is the increase in compliance and efficiency costs of a CGT is outweighed by the reduction in investment biases and improvements to the fairness, integrity, and fiscal sustainability of the tax system. The minority view is that New Zealand should continue with an incremental approach to extending capital gains taxation, as circumstances dictate.

The Final Report notes that there are options over coverage of CGT assets and also timing of introduction (e.g. phasing in of certain asset classes or for certain taxpayers).

The Final Report also highlights the importance of effective implementation particularly given the Government's stated timelines. It recommends a fully resourced Inland Revenue (including overseas expertise) so that it has the capability to develop any new law.

Specific design issues

The key CGT design recommendations:

CGT assets (majority recommendation)

- All **land and buildings** other than the **family home** (the "excluded home"). This is all residential rental properties, holiday homes, second homes, foreign land, agricultural land, and commercial and industrial buildings.
- **New Zealand and Australian shares**. Foreign shares should continue to be subject to deemed return taxation under the Fair Dividend Rate (FDR).
- **Business Assets**.
- **Intangible property**, including intellectual property and business goodwill.

Non-CGT assets (excluded assets)

Personal assets (e.g. jewellery, art, motor vehicles and boats) and the excluded home.

Excluded home

- The place that a person owns and which is their home by reason of family or personal connections. The expectation is that a couple will generally have only one excluded home. There are specific considerations if each partner genuinely lives separately.
- An excluded home can be held directly or indirectly – e.g. by a trust but the settlor must occupy the property as their principal residence or, if occupied by a beneficiary, they must be irrevocably entitled to the property.
- The exemption will be limited to land that is the lesser of 4,500m^2 and the area required for reasonable enjoyment and occupation of the house.
- Apportionment rules are proposed for partial income earning use (e.g. home offices).

CGT rates, discounts and social policy impacts

- The marginal rates (for individuals, 28% for companies) would apply.
- No adjustment for inflation.
- Capital gains should be included for determining any social policy entitlements that are currently calculated based on taxable income.

When should the CGT apply

- When the CGT asset is sold or transferred or there is a specific "realisation event" (such as migration from New Zealand) or a change of use (e.g. from rental property to excluded home or business to private asset).
- However, a different rule is proposed for Portfolio Investment Entities' (PIEs) Australasian equity investments. These should be subject to accrued taxation to make the rules workable. (The report notes that discounting gains, or reducing PIE tax rates, could be considered to align accrued taxation for PIEs with realised taxation for others).

Deferral of CGT liabilities ("rollover" relief)

- Rollover relief should be limited to:
- Inheritances and relationship property transfers.
- Involuntary events, such as insurance proceeds for natural disasters and compensation for Crown acquisitions.
- Certain transactions involving Māori collectively-owned land.
- Small business sale of assets to acquire replacement assets.
- Business reorganisations with no changes in ownership in substance (such as when a sole trader incorporates or transfers within a wholly-owned group).

Timing and transition

Gains made after a "valuation day" (e.g. 1 April 2021 if that is the date of application) should be taxed. (This would capture all CGT assets held on and after the valuation day.)

Different/flexible valuation options should be available with appropriate IRD guidance on their application. These include:

- Ability to use Comparable Value (e.g. QV) or Ratings Valuations for property.
- Default valuation methods if no valuation is determined – e.g. apportionment of the gain on a straight-line basis.
- The option to get an independent valuation up to 5 years from valuation day.

A "median rule" is recommended to avoid tax on 'paper' gains or losses (other than for listed shares). The taxable gain (or loss) would be based on the sale price less the middle value of actual cost, the value on valuation day and the sale price.

Capital losses

No general ring-fencing of capital losses to other (or future) capital gains, except for:

- Portfolio listed share investments.
- Where there is risk of manipulation (e.g. transactions with associates).
- Losses on assets held on valuation day.

No losses should be allowed for private use land (e.g. on sale of holiday or second homes).

Specific tax regimes

Specific rules are proposed for corporate groups and managed funds (including listed and multi-rate PIEs) to integrate a capital gains tax.

Our thoughts on extending the taxation of capital gains

There is much detail, in the Final Report and the background papers, to consider on the CGT. As with the Government, we reserve final judgement on the recommendations until we have been able to consider them. In particular, the minority view, not detailed in the Final Report, and the analysis of the impact of the CGT both need to be considered.

As a first reaction, it appears the TWG has drawn the line as far as possible at "simpler". However, there is clearly room for disagreement on whether that line is correctly drawn.

Importantly, there is consideration of possible relaxations of the current system should a CGT be introduced. This includes the availability of imputation credits and tax losses to companies. The continuity rules are in large measure due to the absence of a CGT.

The taxation of PIEs has been a thorny problem. PIE systems and processes are geared to regular tax calculations which does not sit well with a realisation based CGT. The TWG recommends an accrual basis which means that PIE investors will be taxed earlier than if the investment was direct. This is balanced by a lower rate applying and the fact that tax losses would be immediately available. That seems to be an appropriate line to draw bearing in mind that much of the KiwiSaver savings in particular are in investments which are already fully taxed.

Other key recommendations

The TWG's other key recommendations can be grouped into the following broad areas:

Encouraging environmental and ecological outcomes

- Make the **Emissions Trading Scheme** more "tax-like" by providing greater guidance on pricing and auctioning of emissions units and ensure emissions from all sectors (including agriculture) are appropriately priced.
- Consider allowing employers to **subsidise public transport** use by employees without FBT costs.
- Review existing **farming, forestry and petroleum mining** tax rules to remove concessions that degrade natural capital and consider concessions to enhance natural capital.

Simplifying business tax

- Allow deductibility for business "**black hole**" (i.e. non-deductible/depreciable) expenditure over 5 years.
- Consider a $10,000 threshold for automatically deducting **feasibility expenditure**.

- Increase the **provisional tax thresholds** and the threshold for automatically deducting **legal costs** (and consider extending this to **other professional fees**).
- **Simplify FBT**, including the **entertainment adjustment**.
- Greater flexibility in the issue and validity of IRD **exemption and special tax rate certificates**.
- Consider **compensating tax withholding agents** if additional withholding obligations are imposed on them.
- Review the **BEPS hybrid mismatch** rules' application to small businesses and simple transactions.
- Consider relaxing tax loss continuity rules for **innovative start-up companies**.
- Consider **deductibility** for acquisition of **goodwill** (if goodwill is subject to taxation on sale/transfer).
- Consider a carefully designed tax regime to encourage investment in **large nationally significant infrastructure projects.**
- Review and simplify the taxation of **non-resident employees** (e.g. by requiring consideration of taxation of transitory employees at year-end only).

Buildings and housing

- If taxation of capital gains is extended to property generally, consider **restoring tax depreciation for commercial, industrial and multi-unit residential buildings at 1% per annum.**
- Alternatively, provide tax relief for **seismic strengthening** up to 67% of the new building standard (with costs depreciable over 30 years).
- Consider taxation measures to encourage more **environmentally friendly buildings** (this could be funded by environmental tax measures).
- **Remove rental loss ring-fencing**, if taxation of capital gains is extended to residential rental properties.

Encouraging retirement savings

- Targeted **KiwiSaver measures**. (See revenue neutral packages for the retirement savings options considered.)
- The TWG estimates that all of the packages, including taxing more capital gains, would result in a net tax reduction for KiwiSaver members with incomes up to $70,000 (with Package 3, which has an explicit savings focus, also benefiting those on incomes higher than $70,000).

Progressivity in the income tax

- A preference for **targeted tax relief** rather than a tax-free threshold if the aim is to increase the net incomes of those on lower incomes (with equivalent increases in benefit levels to ensure fair treatment). (See packages.)
- A range of recommendations to source **better information on New Zealanders' wealth**, including oversampling of the wealthy in surveys, a question on wealth in the census, regular IRD analysis of the tax paid by high wealth individuals, and commissioning research to estimate the wealth of individuals.

Our thoughts on the other recommendations

There is a broad range of recommendations. They cover those noted above, some already discussed in the Interim Report (which remains as recommendations) and others not detailed (for example, removing the New Zealand Superannuation Fund as an income taxpayer). These will impact taxpayers differently – for some they will be positive and for others negative.

Some of these recommendations are new. They set the path for future work as the Final Report does not provide final answers. (For example, the review of farming, forestry and petroleum mining tax regimes discusses the principles of the review only).

To the extent these items form part of a recommended package, they need to be considered in conjunction with the CGT proposed. The detail, as usual, requires careful consideration.

Frameworks and Transfer system

The Final Report further expands on the Wellbeing and Māori frameworks outlined in the Interim Report. These will take some further consideration. However, we expect that the work done by the TWG will form the basis of the continued development of these frameworks. They will become more important features of New Zealand's tax policy settings.

As with the last TWG, the transfer system was outside its terms of reference. This is an important exclusion as the highest effective marginal tax rates are not faced by those on high incomes and taxed at 33%. It is lower income earners who can face effective marginal tax rates at up to 100%.

The transfer system is part of the work of the Welfare Expert Advisory Group (WEAG). Although the TWG has some comments in the interaction of the tax and transfer systems, it is the WEAG recommendations will affect the overall balance of the system. These will need to be factored into the assessment of the TWG's report.

In closing

The TWG has come down firmly on the view that a CGT is warranted on fairness grounds. It expects that a wider definition of taxable income will produce a better result in terms of taxing those on the same income at the same amount. This provides an opportunity to make the system more progressive (with lower personal tax) and fairer as it allows the tax base to be modified for business and investors.

Implementation of tax review recommendations have historically taken a while to implement (if they have at all). The TWG's work is likely to have a longer term impact as well as the immediate conversation that has been started.

Although when the detail is considered, you may disagree with the judgement call, the work of the TWG is valuable and important. The work of the TWG should be acknowledged.

In the meantime, its 99 recommendations remain "not out".

We would be pleased to discuss the recommendations and their impact with you.

Contact us

John Cantin
Partner, Tax
Wellington
T 04 816 4518
M 021 802 126
E jfcantin@kpmg.co.nz

kpmg.com/nz/tax