THE UNITED STATES CAPITAL GAINS TAX REGIME AND THE PROPOSED NEW ZEALAND CGT: THROUGH ADAM SMITH’S LENS

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Political commentators have long said that the enactment of a comprehensive capital gains tax (CGT) in New Zealand (NZ) would be political suicide. However, sentiment towards a CGT in NZ has softened more recently with a number of commentators as well as business and political leaders supporting the introduction of a CGT.

In both the 2011 and 2014 General Elections the centre-left Labour Party campaigned on inter alia introducing a comprehensive CGT levied at a rate of 15 per cent. They lost in both elections but on the basis that a CGT is now part of the NZ political agenda of the left-of-centre parties coupled with the current mixed member proportional (MMP) electoral system (which lends itself to coalition-based governments) it is arguably only a matter of time before a CGT is introduced in NZ by a Labour-led coalition.

This paper, using Adam Smith’s canons for a good income tax, considers the Labour Party CGT proposal and the United States (US) experience in dealing with capital gains. It notes that the NZ proposals are consistent with CGT regimes generally, such as it being realisation-based and not permitting indexing, but may involve complexities and pitfalls that the US system has previously encountered.

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1. INTRODUCTION

1.1 Background

It has been a long held belief in New Zealand (NZ) that the enactment of a comprehensive capital gains tax (CGT) in NZ would be ‘[a] sure-fire path to political suicide’.¹ Former Prime Minister, the Retired 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’.² In 2009, when the NZ Treasury Secretary John Whitehead suggested NZ should address the issue of taxing capital gains from property investment, he was quoted in one newspaper report as stating that his comments were made ‘[a]t the risk of being chased down by an angry crowd with pitchforks and flaming torches’.³

More recently some commentators have suggested that there may be a change in the mood of the nation toward the adoption of a CGT. The New Zealand Herald’s Fran O’Sullivan said the 2013 Mood of the Boardroom survey showed support was building in the business community for a tax on capital gains.⁴ Backing for a CGT is also evident among the wider

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¹ Bob Edlin, ‘A Sure-fire Path to Political Suicide’ The Independent (online), (New Zealand), 5 February 2008, at 14.
² Barrett and Veal, referring to overseas experiences, conclude ‘Memorable 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 (n 25).
³ ‘Capital Gains Tax Promoted’ The Press (Christchurch, 4 June 2009), B4.
⁴ Ben Chapman-Smith, ‘Capital Gains Tax No Good Unless Comprehensive – English’ The New Zealand Herald (online), (New Zealand) 25 July 2013. Deloitte New Zealand Chief Executive Thomas Pippos, similarly observes ‘Even for certain traditional naysayers there is an acceptance that a CGT is an inevitable part of our future tax landscape that once enacted will not, like the short-lived R&D regime, ever be removed’; Thomas Pippos, ‘Capital Gains Tax an Inevitable Part of the Future Landscape’ The New Zealand Herald (online), (New Zealand), 23 July 2013.
On 14 July 2011, as part of its tax policy for the 2011 General Election, the centre-left Labour Party (Labour) proposed introducing a capital gains tax (CGT) levied at 15 per cent. The proposal was retained as part of Labour’s 2014 tax policy. While the Labour Party was unsuccessful in both the 2011 and 2014 General Elections, it has indicated it will consider tax reform (including a possible CGT) if it forms the next government after the 2017 General Election. The left-of-centre Green Party of Aotearoa New Zealand (Greens) and the smaller Mana Party also support a CGT for NZ. On the basis that the Mixed Member Proportional (MMP) electoral system produces coalition-based governments and the Greens and

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). This result came on the back of the introduction by the Reserve Bank of New Zealand of its loan to value ratio (LVR) restrictions which limit low deposit loans aimed at inter alia easing house price inflation; Michael Fox, ‘Kiwis “Ready” for Capital Gains Tax’ The Press (Christchurch, 12 November 2013), A5.


The Greens tax policy has included the introduction of a CGT for a number of years; see ‘Green Taxation and Monetary Policy Summary’<www.greens.org.nz/policysummary/green-taxation-and-monetary-policy-summary>.

In the 2011 and 2014 General Elections the Mana Party campaigned on introducing a CGT on all assets except the family home and Maori land, see for example <mana.net.nz/wp-content/uploads/2011/06/Final-for-release-Economic-Justice-25-September-2011.pdf> and <mana.net.nz/policy/policy-economic-justice/>, respectively. The CGT policies of the Greens and Mana have not been considered in this paper as their proposals are much less detailed.
Labour (at least) are likely coalition partners in a future government, a CGT in NZ is a possibility in the medium term

1.2 Adam Smith’s Canons of Taxation

This paper considers Labour’s CGT proposal, which is contained in the document ‘Labour’s Fairer Tax System Explained…’ (hereafter the policy statement), and identifies potential issues that may need consideration given Adam Smith’s canons of taxation. Adam Smith, in his seminal economic work suggested four canons of a good tax system. His work has universally been recognised as a model to try and be emulated by economists, tax policy makers and academics. He wrote that a tax system should be:

1. Equitable – ‘The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state’. He went on to say that ‘It is not unreasonable that the rich should contribute to the public expense not only in proportion to their revenue but something more than that proportion.’ Commentators note that equity

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13 For example, Alley and Bentley observe with reference to Smith’s canons of taxation: ‘If the number of times they are quoted is any guide, they are still relevant to today’s tax environment’; Clinton Alley and Duncan Bentley, ‘A Remodelling of Adam Smith’s Tax Design Principles’ (2005) 20 Australian Tax Forum 579, 586. In their article, Alley and Bentley also refer to a variety of principles (for an efficient tax system) as utilised in various reports, including the Carter Report (Canada, 1966) and Asprey Report (Australia, 1975); ibid 586-588.
14 Smith, above n 12, Book V, Chapter II, Part II, 310.
15 Ibid 327.
has two main dimensions – horizontal and vertical equity.\textsuperscript{17} Horizontal equity would ensure that similarly situated taxpayers would pay an equivalent tax, while vertical equity is the principle that unequally situated taxpayers should be taxed on their ability to pay.

2. Convenient – a tax should be readily and easily assessed, collected, and administered.

3. Certain – a tax should be consistent and stable.

4. Efficient (or economy of collection) – compliance and administration of a tax should be minimal in terms of cost.

Economists and others have added other principles to those propagated by Smith, including:

1. Adequacy – a tax should have the ability to produce a sufficient and desired amount of revenue to the taxing authority.\textsuperscript{18}

2. Achievement of social and economic effects – the use of taxes to reallocate resources to achieve various specific social and economic objectives.\textsuperscript{19}

3. Neutrality – a tax should not encourage inefficient allocation of resources by being so extreme that taxpayers make counterproductive economic decisions.\textsuperscript{20}

Many of these elements include a simplification factor. For example, convenience, certainty and efficiency all have strong simplification elements. Smiths’ canons of taxation and the additional principles mentioned above are also collectively

\textsuperscript{16} See for example, Simon James, \textit{A Dictionary of Taxation} (Edward Elgar, United Kingdom, 2012), 95-96.

\textsuperscript{17} Kevin Holmes, \textit{The Concept of Income – A multi-disciplinary analysis} (IBFD Publications BV, Amsterdam, 2000), 19.


\textsuperscript{19} See, for example, Ross and Burgess, \textit{Income Tax: A Critical Analysis} (LBC Information Services, NSW, 1996), 28.

\textsuperscript{20} Ibid 26.
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referred to as the principles of a good tax in the remainder of this paper.

Section II of this paper briefly outlines the background to Labour’s CGT proposal. Section III contains an analysis of the proposal and identifies horizontal and vertical equity, convenience of payment, administration and complexity issues requiring further consideration. It also looks to the United States of America’s (US) long standing experience with an integrated capital gains tax and considers inter alia pitfalls to avoid, and problems and complexities that have arisen in the US system. The US CGT was implemented in 1913. Section IV discusses issues that policymakers and the Expert Panel need to consider if a CGT is to be introduced in NZ. Concluding observations are made in Section V. Unless stated otherwise all monetary references are to the NZ dollar.

2. LABOUR’S CGT POLICY INTRODUCED

Not unexpectedly the purpose of Labour’s CGT proposal is couched in somewhat political and populist rhetoric and echoes Adam Smith’s equity canon for a good income tax:

It’s not fair for people to have to pay tax on every dollar they earn from wages or interest on their money in the bank while others are making huge profits buying and selling assets without paying any tax … This tax switch is about creating a fairer tax system. In fact, under Labour, the overwhelming majority of Kiwis will wind up paying less tax not more.21

Reference to the CGT ‘creating a fairer tax system’ in Labour’s policy statement resonates with commentators, such as Evans and Sandford,22 and groups such as the Organisation for Economic Co-operation and Development (OECD)23 who have

21 Labour Party, above n 7.
23 In its June 2013 economic survey of New Zealand, the OECD highlighted the lack of a capital gains tax as a weakness in the New Zealand tax policy.
long highlighted the inequity present in the NZ tax system in the absence of a comprehensive CGT.

The policy statement comments that Labour’s proposed CGT will be broad based and comprehensive, aimed at avoiding high compliance costs associated with a large number of significant exemptions and will follow the same approach as adopted in other jurisdictions including the US and Australia. With respect to arguments of complexity and administrative costs, Labour would draw on the experiences of other countries. The policy statement also acknowledges the complexity inherent in the current NZ tax system due to the absence of a comprehensive CGT: ‘some tax experts have said that the lack of a CGT in NZ has caused considerable complexity, requiring arbitrary and ad hoc tax rules to limit the exploitation of this exemption.’ As will be discussed in this paper, NZ will arguably be swapping one area of complexity for another, so the key issue is that under the present tax system the government is losing revenue, and under a tax regime which incorporates a CGT, additional tax revenue will be collected.


24 The policy statement lists a broad range of assets to which the CGT will apply; Labour Party, above n 7, 9.
26 Ibid 18.
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The policy statement outlines some high-level details of the CGT regime and how it could operate.\textsuperscript{28} It also contains a useful ‘Questions and Answers’ section\textsuperscript{29} (with 26 questions covering the rationale for the CGT and practical operational issues) followed by a table covering five pages titled ‘When will the Capital Gains Tax Apply?’\textsuperscript{30} In addition, the policy statement lists a range of assets that will be subject to the CGT including land and property (with the exemption of the main residence), shares in a company, goodwill, minerals and precious metals, intellectual property rights (patents, trademarks).\textsuperscript{31} It estimates, based on Australia’s experience, that the CGT would impact in any one year less than 10 per cent of taxpayers (or about 267,000 people).\textsuperscript{32}

It is expected that an Expert Panel would initially be appointed to ‘provide top level advice to guide the design of the CGT’\textsuperscript{33} before proceeding through the generic tax policy process (GTPP) to enactment.\textsuperscript{34} The panel would include senior experts from the fields of tax policy, economics, law, accounting and social policy with support by a secretariat.\textsuperscript{35}

3. THE PROPOSED NZ CAPITAL GAINS TAX AND THE UNITED STATES EXPERIENCE

This section considers key aspects of Labour’s CGT policy derived from their policy statement and includes discussions of how the US handles similar concepts, problems or resolutions of

\textsuperscript{28} Labour Party, above n 7, 6 – 14.
\textsuperscript{29} Ibid 15-18
\textsuperscript{30} Ibid 19-23.
\textsuperscript{31} Ibid 9.
\textsuperscript{32} Ibid 16.
\textsuperscript{33} Ibid 18.
\textsuperscript{34} The GTPP incorporates consultation and public submissions to a select committee; see Adrian Sawyer, ‘Reviewing Tax Policy Development in New Zealand: Lessons from a Delicate Balancing of “Law and Politics”’ (2013) 28 Australian Tax Forum 401.
\textsuperscript{35} Labour Party, above n 7, 18.
issues relative to the principles of taxation. Based on this analysis, we conclude this section with recommendations concerning aspects of Labour’s proposal.

### 3.1 Capital Gains Tax Rate

The proposal would impose a 15 per cent capital gain rate on individual’s net gain, with no indexation for inflation. This rate compares favourably with individual income tax rates on ordinary income in NZ which range from 10.5 per cent to 33 per cent\(^{36}\) and ‘makes some allowance for the effect of inflation’.\(^{37}\) It also reflects that there is ‘some risk associated with investment for capital appreciation as opposed to other investments’.\(^{38}\)

The policy statement comments that the tax base is not indexed for inflation due to the practical difficulties of indexation, as evidenced by the abandonment of indexing in the

\(^{36}\) The NZ income tax rates for individuals are:

<table>
<thead>
<tr>
<th>Income bracket</th>
<th>Tax rate</th>
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<tbody>
<tr>
<td>NZD 0 – NZD 14,000</td>
<td>10.5 per cent</td>
</tr>
<tr>
<td>NZD 14,001 – NZD 48,000</td>
<td>17.5 per cent</td>
</tr>
<tr>
<td>NZD 48,001 – NZD 70,000</td>
<td>30.0 per cent</td>
</tr>
<tr>
<td>NZD 70,001 and over</td>
<td>33.0 per cent</td>
</tr>
</tbody>
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\(^{37}\) Labour Party, above n 7, 7.

\(^{38}\) Ibid. With respect to compensating for inflation, then Labour Finance spokesperson (and now Labour leader) David Cunliffe defended the adoption of the 15 per cent rate on the basis: ‘You can do that [account for inflation] in two ways. You can either say 50 per cent of it, which is a proxy for inflation, is taxed, and it’s all taxed at the marginal tax rate as it were income. Or you can say all of the gain will be taxed at a lower rate. It’s a similar answer.’; Alex Tarrant, ‘Labour’s second best, politically palatable capital gains tax stance; Why not actually do what the IMF and OECD recommend?’ (2012) interest.co.nz, 2 <www.interest.co.nz>.
Australian and the United Kingdom CGT regimes. In fact, at least in respect of Australia, it has not abandoned indexation; rather it is frozen as at 30 September 1999. In addition, the low CGT rate will reduce the risk of taxpayers holding onto assets, ie, ‘lock-in’ effects.

The proposed 15 per cent capital gains tax rate is virtually the same as the one imposed in the United States, which also does not allow for indexing.

At this point in the paper it is worth noting that although the capital gains tax 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 vertical equity criterion (and is subject to criticism discussed following), since NZ presently does not tax capital gains, this is a move toward (vertical) equity. This fact is acknowledged by the NZ

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39 Labour Party, above n 7, 7. 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 22, 404.
41 In the United States, 15 per cent is also the normal rate on net long term capital gains; for lower earning taxpayers there is a 0 per cent capital gain rate, and for the wealthy (greater than USD 400,000 of ordinary income) a 20 per cent rate, a special rate on collectables of 28 per cent and a 25 per cent rate on real estate gains attributable to depreciation. Note that since NZ does not permit depreciation of buildings, this latter rate would be inapplicable. To give some frame of reference the highest marginal rate on ordinary income in the US is about 39.6 per cent. Internal Revenue Code (US) section 1(h) also includes a zero tax rate for individuals with low net ordinary taxable income (below USD 70,000 for married and USD 35,000 for single). In contrast, capital gains in Australia are subject to tax at the individuals marginal tax rate, ie, potentially at 45 per cent, although there is a concession for individuals and family trusts whereby only 50 per cent of the capital gain is taxed if the asset is held for more than 12 months, thus halving the effective tax rate on the gain.
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.  

While there is some rationale for the 15 per cent CGT rate, the low rate ‘negates many of the benefits of introducing the tax’.  

The reality is that as it is lower than three of the present four tax brackets for individual taxpayers it will affect the neutrality of the tax system and an arbitrage opportunity will exist between income from capital and income from labour (an opportunity made all the more attractive if, as Labour propose, the top marginal tax rate is ultimately increased).

Three ways to ameliorate the horizontal and vertical equity arguments brought up by commentators is to expand the income bracket bands; reduce the ordinary income rates at the lower income levels; or impose a zero tax rate on lower income earners capital gains.  

The latter proposal will be particularly useful within the NZ tax system as it would allow many PAYE taxpayers to avoid having to file a tax return since their non-PAYE income would not be subject to tax. So for example, following the US approach, if in NZ a taxpayer’s net ordinary income is below the second income threshold (NZD 48,000),

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44 As already mentioned the United States addresses the issue of vertical equity through a zero tax rate for individuals with low net ordinary taxable income (below USD 70,000 for married and USD 35,000 for single).
45 Under the Pay-As-You-Earn (PAYE) system employers are required to withhold tax from employee remuneration and must account to Inland Revenue for the amounts withheld. As a consequence these employees are not required to file an income tax return.
then any capital gains will be not taxable to the extent net ordinary income plus capital gains does not exceed NZD 48,000.

Example: Marc is an employee who has net income of NZD 30,000 from wages and has a capital gain from the sale of shares of NZD 4,000, the capital gain would be taxed at zero as the combined income of NZD 34,000 is below the second income bracket of NZD 48,000.

Cadelis sounds a cautionary note, observing generally that ‘[t]he preferential treatment of capital gains is said to be ‘the single most important tax loophole that is responsible for turning a generation of dedicated law and accounting graduates into the greatest masters of needlepoint in the history of the law.’’ 46 The current difficulties in ‘differentiating between income and capital will continue to be perpetuated despite the introduction of a CGT.’ 47

3.2 Point of Taxation

3.2.1 Taxation on realisation

The CGT will be applied on realisation (typically the point of sale or exchange) rather than as the gain accrues. 48 If, for example, the CGT is triggered on ‘disposal’, the obvious

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46 Stephanie Cadelis, ‘A Critique of Labour’s Recent Capital Gains Tax Proposal’ (August 2011) Taxation Today 4. Cadelis attributes the quote to an American commentator in Neil Brooks, ‘Taxing Capital gains is Good for the Tax System’ (paper prepared for the Portfolio Committee on Finance, Parliament of the Republic of South Africa, 26 January 2001). 8. Similarly, the National Treasury (South Africa) commented that a CGT which treats capital gains preferentially will not eliminate the complexities of the capital-revenue distinction; rather it ‘will still create the same opportunities for tax arbitrage and avoidance which will be fully exploited by the well-advised and wealthy taxpayers in South Africa’; National Treasury (South Africa), ‘Capital Gains Tax in South Africa’ (Briefing by the National Treasury’s Tax Policy Chief Directorate to the Portfolio and Select Committees on Finance, 24 January 2001), 14 <www.ftomasek.com/NationalTreasury.pdf>.

47 Cassidy and Alley, above n 43, 120.

48 Labour Party, above n 7, 11.
question is: ‘What is a ‘disposal’?’ Based on the United States experience, it should include sale or exchange as to exclude an exchange in assets would potentially open up a large loophole in the regime.

The policy statement does single out two cases requiring specific exceptions. First, inheritance on death, will not be considered a CGT ‘event’, but inter vivos gifts will be considered a sale or exchange. The donor will be subject to CGT on the market value of the asset.

Example: Deborah is a wealthy individual and gifts each of her four children 1,000 shares of Telecom Corporation of New Zealand Ltd (Telecom) stock when its value was NZD 2.40 a share and her cost was NZD 1 per share. She would recognise a capital gain on the gift to each child of NZD 140 [(2.40 - NZD 1) x 1000 shares] at the time of the gift and each child would have an adjusted basis in each share at fair market value of NZD 2.40.

This example raises the issue of convenience of payment in the case of non-cash gifts in the event that the donor does not have the cash resources to pay the tax. However, it does prevent the lock-in effect. In the United States, gifting does not trigger a capital gain as it is not a recognition event.

Following the treatment in Australia, the policy statement provides that capital gains on inheritance will be rolled over to the heir and subject to CGT based on the gain since valuation day (see Section III C Valuation day of this paper) on the

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49 Cassidy and Alley, above n 43, 100; 111-113.
50 Labour Party, above n 7, 11. Capital gains on inheritance passed on after death will be rolled over to the heir and only payable when subsequently realised - the CGT being charged on the difference between the v-day value and realisation amount; ibid 19.
51 Ibid 11.
realisation of the asset by the heir. Thus, if Deborah waited until her death, no capital gain would be triggered, but the heirs would take her adjusted basis of NZD 1 per share when they dispose of the Telecom shares.

In the US, one of the largest loopholes and creator of a lock-in effect is the fact that upon the death of the property owner, their adjusted basis moves by law to fair market value and the built-in capital gain disappears. The system therefore strongly encourages the lock-in effect. Since NZ would treat this as a carry-over basis transaction, it will largely ameliorate this complicating issue. However, since on gifting, a deemed sale occurs, it will reduce the incentives to gift to the next generation. The Expert Panel might consider a realisation at death with some extended payment schedule to reduce the consequent inconvenience of payment problems and to encourage gifting.

The second case mentioned by the policy statement as requiring specific treatment is capital gains on assets transferred between a couple after legal separation or a divorce. It proposes that any gains will be rolled over and only be payable upon the subsequent realisation of the asset. This mirrors the United States treatment under Internal Revenue Code (US) section 1041.

Example: Dick and Jane have been married for eight years and decide to get divorced. They own some investment property with an adjusted basis of NZD 100,000 and a fair market value of NZD 190,000. Dick transfers the property to Jane as part of the divorce, so Jane will continue to have a NZD 100,000 basis in the land and Dick will not recognise any gain on the transfer.

52 Ibid 11. For a discussion of the Australian experience of rollover relief on death see Cassidy and Alley, above n 43, 122-123.
3.2.2 Short and long term gains

The Expert Panel will need to explore whether there should be favourable capital gain treatment for assets held for longer than a specific period (and what that holding period should be). In the United States, such a concession exists and, for most assets, it is a holding period of more than 12 months. Capital gains arising from the sale of assets within the 12 month period are taxable like ordinary income. It would be simpler not to have such a distinction but a holding period eliminates from capital gains tax treatment many day traders and dealers, as they typically turn over their stock in less than one year (see Section III G Treatment of traders of this paper). The longer the holding period, the less problem there is distinguishing traders and dealers from actual investors. Further, as a matter of tax policy, one of the justifications for distinguishing between short and long term gains is the risk of holding the asset over a long period of time. No holding period is counter to that concept.

3.2.3 Instalment sales

Another issue, which would fall under the convenience of payment canon, is what the tax treatment is if a capital gain asset is sold with a deferred payment agreement (often characterised as seller financing). To recognise the gain at the time of sale, without any cash to pay the tax would be very burdensome. Accordingly, the Expert Panel might adopt the United States Internal Revenue Code (US) section 453 Instalment Sale treatment. This essentially matches the cash received and the tax liability. Basically a gross profit percentage is computed and multiplied by the cash received. However, as will be shown below, it does introduce an element of complexity to the tax system to prevent certain abuses.

Example A: Stewart owns a rental apartment with an adjusted basis of USD 350,000 and a fair market value of USD 1,000,000. The gross profit ratio would be the USD 650,000 gain divided by USD 1,000,000 potential collections or 65 per
cent. If the terms of the sale were USD 200,000 down and 3 payments of USD 266,667 each in years 2, 4, and 6, then in the year of sale USD 130,000 (USD 200,000 x 65 per cent) would be recognised. In year 2, USD 173,333 (USD 266,667 x 65 per cent) would be the capital gain recognised, as would be true for years 4 and 6. This assumes that a fair rate of interest is due on the deferred payment. An anti-abuse provision is necessary to ensure that interest income is not converted into capital gains. *Internal Revenue Code* (US) section 483 requires a reasonable rate on the instalment notes.

Another potential abuse involves related parties and is often called the ‘Rushing technique’. This strategy involves a primary shareholder in a closely held corporation selling the shares to his or her relatives on an instalment basis with nothing down and the buyers consequently have a high basis in their shares. These related buyers then sell to an interested party for cash and have little or no gain. In NZ, in the absence of a specific anti-avoidance rule, the general anti-avoidance rule (GAAR) arguably could prevent this abuse.\(^{53}\)

### 3.3 Valuation Day

The CGT will only apply to gains or losses accrued from a specific date (eg, date of enactment), labelled ‘valuation day’ or ‘v-day’.\(^{54}\) The approaches adopted in Canada, the United Kingdom and more recently, South Africa, are acknowledged as the basis for this policy.\(^{55}\) This way it will not penalise taxpayers for built in gain appreciation on their investment decisions made prior to the introduction of the CGT. However, it will require a valuation of most assets at v-day and create an ‘Appraisers Right to Work Act’, ie, provides more work for valuers.

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\(^{53}\) Section BG 1 of the *Income Tax Act 2007* (NZ) provides that a tax avoidance arrangement is void as against the Commissioner of Inland Revenue for income tax purposes.

\(^{54}\) Labour Party, above n 7, 10. In the United States the valuation date was March 1, 1913.

\(^{55}\) Ibid 10.
The policy statement is critical of the grand-fathering approach adopted in Australia, where CGT only applies to assets acquired after the implementation of the regime, on the basis that it ‘increases “lock-in” and complexity by creating avoidance opportunities through shifting value from post-CGT to pre-CGT assets. This has in turn increased the complexity of the Australian scheme.’56 Another reason for adopting the ‘valuation day’ approach is that it will generate revenue earlier than a grand-fathering approach.

An issue that will require consideration by the Expert Panel and which is flagged by the policy statement is how to treat assets whose v-day value is below their purchase cost. As an example of a potential option, a median approach is used in the United States for gifted assets when their fair market value is below the donor’s adjusted basis.57

Example A: At v-date, an investment asset’s value is NZD 10,000; its original cost is NZD 14,000 and it is sold for NZD 11,500. No gain would be recognised as it is between the value and original cost.

Example B: same facts, except it is sold for NZD 9,000 (ie, it continues to go down in value). The recognised loss would be NZD 1,000 (NZD 9,000 – NZD 10,000).

Example C: same facts as Example A but it sells for NZD 15,600; a gain of NZD 1,600 (NZD 15,600 – NZD 14,000).

Other operational issues, such as the valuation methods for assets which are not easily valued, will be included within the Expert Panels purview.58 From a practical perspective, if as Labour proposes personal assets and collectables are excluded

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56 Ibid 10. Cassidy and Alley, discuss examples of how a post-CGT asset can be disguised as a pre-CGT asset; Cassidy and Alley, above n 43, 105.
57 While offering no specific solutions, the policy statement also appears to support the use of a median rule; Labour Party, above n 7, 13.
58 Ibid.
assets, then arguably much of de minimis or hard to value assets are already excluded.

However, as discussed later in this article, we recommend that as few assets as possible be excluded from both the CGT and ordinary income regimes due to complexity and revenue considerations. Instead a zero tax rate on lower income taxpayers or a minimum capital gains exemption threshold may be more practicable.

3.4 Exemptions

3.4.1 The main residence

In line with some other CGT regimes, the main residence will be exempt. While not specifically defined in the policy statement, it refers to the main residence as ‘the residence where you live most of the time.’ Holiday homes (also referred to as baches) will be included as part of the CGT regime as to exempt them would lead to loopholes, as well as definitional and administrative issues. However, CGT will not apply while the family bach is passed down through the generations. This has the potential to create an undesirable loophole but does meet Smith’s convenience principle.

Where the main residence is also used for business purposes, there will be a partial exemption from the CGT for that portion of the property used as the family home. Similarly, in respect of farms, the primary farm residence and surrounding

59 As noted in Section III D Collectables of this paper, the US actually taxes collectables as it makes the system be more progressive as these assets tend to be are owned by wealthy individuals.
60 Labour Party, above n 7, 7. The Australian regime provides that where the property upon which main residence is located is larger than two hectares, the gain on the area that exceeds two hectares is subject to the CGT; Cassidy and Alley, above n 43, 121. A similar rule is found in South Africa; Huang and Elliffe, above n 27, 285.
61 Labour Party, above n 7, 9.
62 Ibid 16.
63 Ibid 10.
land used for domestic purposes (the curtilage) will be exempt from CGT.\textsuperscript{64} The wider land used in the farming business will be subject to the CGT. The approach used to calculate the land used for domestic purposes will be the same as used currently for GST purposes.\textsuperscript{65}

Again, we emphasise that the more exemptions that are allowed, the more complicated and abusive the system will be perceived and become. A better approach may be to have a minimum exclusion that applies to both farms and the principal residence and any gain above that threshold will be subject to CGT. 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)\textsuperscript{66} as long as the taxpayer has owned the home and lived in it\textsuperscript{67} for a minimum of two years out of any of the past five. This exemption also applies to farms and negates the need for a curtilage adjustment as proposed by the policy statement. In the United States this concession has engendered some gaming of selling a principal residence, moving into a vacation home for two years and selling that, benefiting from a total USD 1,000,000 exclusion. We would recommend a five out of eight year waiting period\textsuperscript{68} to avoid these complications. If a taxpayer is forced to move before the two year waiting period (five under our proposal), then a relief provision could be included to prevent hardship. For example, if a change in job or serious health issue forces the taxpayer to move and sell their residence before the 24 month period (or 60 months under our

\begin{footnotesize}
\textsuperscript{64} Ibid 9.
\textsuperscript{65} Ibid 21.
\textsuperscript{66} See Internal Revenue Code (US) section 121.
\textsuperscript{67} If the home is used partly as a business, such as a home office, or a two family home, where one portion of the home is rented out, then the Internal Revenue Code (US) section 121 exemption would only apply to the residence portion.
\textsuperscript{68} This waiting period is consistent with Dave Camp’s Tax Reform Act of 2014 section 1401 proposal.
\end{footnotesize}
recommendation), then a pro rata share of the exclusion would be available.

Example: Adrian, a single taxpayer, has lived in a flat he owns for one and a half years and received a promotion at work that requires him to move hundreds of miles away. He sells his principal residence for a gain of USD 200,000. The allowable exclusion of USD 250,000 would be prorated to 1.5/2 x USD 250,000 or USD 187,500, so that would be the amount excluded and the USD 12,500 [USD 200,000 – USD 187,500] would be taxable at capital gain rates. If his gain had only been USD 120,000, which is less than the prorate limit, all of the gain would be excluded.

While exempting the primary residence may be a political necessity, it reduces the revenue to be raised from the tax and creates complexity.69 With respect to the first issue, Huang and Elliffe note that the unlimited (in terms of dollar amount) exemption from the CGT from the sale of the primary residence in Australia ‘has caused significant loss to the CGT base70 and tax-induced investment in housing.’71 The capped exemption approach adopted in the US limits this revenue loss.

The exemption of the main residence also opens the door to manipulation and the relevant definition will therefore need to be precise.72 The concession may lead to wealthier taxpayers

69 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) (New Zealand), 10 December 2012.

70 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 27, 296. Abelson and Joyeux are reported as ‘estimating the static loss to the tax base to be between AUD 7.2 and AUD 10 billion per year, depending on assumptions about gains growth’; ibid 296.

71 Ibid 296.

72 Cassidy and Alley outline issues faced by Australia with respect to exempting the main residence; Cassidy and Alley, above n 43, 121-122.
investing in bigger and grander family homes (the ‘mansion effect’)\textsuperscript{73} and thus undermine vertical equity.

An exemption for the main residence can be abused in at least two ways. First, a family which owns more than one property could list the properties under different names and thereby each property could qualify for the exemption, eg, the husband and wife separately. In the United States this is taken care of by married filing separately each only receiving USD 250,000 exclusion, instead of USD 500,000 each. Second, a residence could be owned by another entity such as a family trust. In America, if a non-natural person (trust, partnership, S corporation or C corporation) owns the principal residence, no Internal Revenue Code (US) section 121 exclusion is allowed.

If Labour decided to exclude from the exemption residences owned by non-individuals, due to the large number of family trusts in NZ,\textsuperscript{74} many of which will own the primary residence, not to mention residences owned by companies, a period would be required in order for primary residences to be transferred back into individual’s names to qualify for the exemption. This approach, which was adopted in South Africa,\textsuperscript{75} “would be controversial as it would impose significant, albeit one-off, compliance costs on trusts and companies. It would also strike at the heart of one of the legitimate reasons for the establishment of a trust.”\textsuperscript{76} Depending on how the residence has been treated


\textsuperscript{74} The Law Commission estimates that NZ has 300,000 to 500,000 trusts used for a variety of purposes ranging from owning the family home, through to use in business, by charities, and by many, including Māori, to collectively hold land and other assets; Law Commission, Review of the Law of Trusts – A Trusts Act for New Zealand (Wellington, 2013), 6.

\textsuperscript{75} Cadelis, above n 46, 6. Individuals who owned their primary residence in a trust or company were given until 31 December 2012 to undertake the transfer (ie, a little over 11 years from the date the CGT took effect).

\textsuperscript{76} Maples, above n 11, 18.
for tax purposes by the trust or company, tax consequences could also arise on the transfer into an individual’s name, for example the crystallisation of depreciation recovery on chattels and the house.\footnote{Buildings were able to be depreciated up until (and including) the 2010/2011 income year. A nil rate of depreciation applies for all buildings, with effect from the 2011/2012 income year, ie, effectively owners can no longer claim depreciation on the building.}

The policy statement does accept that a family home may be placed in a trust ‘to mitigate business or creditor risk’\footnote{Labour Party, above n 7, 18.} and states ‘It’s not our intention to penalise those who have done this.’\footnote{Ibid 18.} How this would pan out in practice remains to be seen but there appears an acknowledgement in these statements of the genuine non-tax reasons for a trust owning a private residence.

The preferred option, from a simplicity perspective, would be for the exemption to only apply to natural persons. However, given the widespread use of trusts\footnote{The use of trusts in NZ to own private residences and personal property is due in part to the fact that if these assets are held in the individual’s own name they are not protected from creditors in the event of bankruptcy. An issue for future consideration and which is beyond the scope of this paper is whether to limit the use of trusts NZ should follow the US approach and provide protection of these assets on bankruptcy.} to hold residences in NZ, a more palatable alternative to so limiting the exemption could be to include within the definition of ‘main residence’ houses owned by trusts (and possibly companies), or to modify the associated (related) persons rules to cover this situation. Existing trusts and possibly companies that held private residences for legitimate business purposes would also be covered by the exemption regime, but prospectively they would not be covered. This would allow horizontal equity for past behaviour which is a theme of the CGT proposal.

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3.4.2 Personal use property

In the United States, personal use property gains are taxed under the capital gain rules but losses are not deductible as it is viewed as inappropriate to subsidise personal use and normal wear and tear and deterioration. This eliminates the concern that capital losses will be offsetting real capital gains. By contrast, the Labour party proposal would entirely exempt items such as boats, furniture, electrical goods and household items. The policy statement makes it clear that the exemption will apply to ‘luxury’ items such as ‘the millionaire’s super yacht’, on the basis such assets 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). The US approach takes care of this concern and acknowledges that allowing deductions for losses on such assets is bad policy both from the vertical equity and the public perception perspective.

3.4.3 Collectables

The policy statement also exempts ‘collectables’ such as jewellery, antiques, artwork, rare folios or stamp collections. The stated rationale for exempting this category is threefold – first, a CGT on these items would be intrusive, second it would result in high compliance costs and, finally it would not raise significant revenue. However, the policy statement makes it clear that the current tax position for taxpayers who regularly

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81 The reality of this approach is that these assets (such as motor vehicles) usually decline in value so there is no CGT exposure for most taxpayers on the sale of personal use assets.
82 Labour Party, above n 7, 8. For these purposes personal property is defined as property ‘used or kept mainly for the personal use or enjoyment of yourself or your associates’; ibid 8.
83 Ibid 17 (Question 18).
84 Ibid 8. South Africa excludes most personal use assets such as motor vehicles, certain types of boats, caravans, artwork, postage stamp collections, furniture and household appliances; Huang and Elliffe, above n 27, 285.
85 Labour Party, above n 7, 8.
trade in these items (and personal property)\textsuperscript{86} will continue, ie, they will be subject to income tax at their marginal tax rate.\textsuperscript{87}

In the United States, the opposite position has been taken in that investment in such collectables is not to be encouraged and gains on these items are therefore taxed at a higher capital gain rate of 28 per cent. This also assists keeping the income tax system progressive as many of these items are owned by the wealthy 1 per cent of individuals. Also, as a policy consideration, 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 innovation, job creation etc.

Recognising the potential avoidance concerns that may arise with the exemption proposed by Labour, the Expert Panel will be asked to consider how to control these and related issues. This category of exemption is likely to influence behaviour in favour of these forms of investment compared with others, such as shares, which will be subject to the CGT. The definition of collectables will therefore need to be clear and robust and for this reason (along with those already mentioned) in our view the US approach is clearly preferred.

3.4.4 Other exemptions

The CGT will also not apply to withdrawals from retirement savings schemes, such as KiwiSaver;\textsuperscript{88} lump sum compensation such as for redundancy, Accident Compensation payments\textsuperscript{89} or

\begin{itemize}
\item \textsuperscript{86}See ‘Questions and Answers’ (Question 17); ibid 17.
\item \textsuperscript{87}Section CB 5 of the \textit{Income Tax Act 2007} (NZ) provides that amounts derived from the disposal of personal property are income if the person’s business is to deal in that kind of property.
\item \textsuperscript{88}KiwiSaver is a government supported initiative to assist New Zealanders to save for their retirement.
\item \textsuperscript{89}The Accident Compensation Corporation (ACC) provides comprehensive, no-fault personal injury cover for all New Zealand residents and visitors to New Zealand.
\end{itemize}
court costs, a life insurance policy which is surrendered or sold, winnings or losses from gambling and medals.\textsuperscript{90}

In the United States, gambling and lottery winnings are ordinary income so the capital gain regime would not apply to them. In respect of life insurance, some taxpayers have sold their future receipts and the courts have held that the amount received is ordinary income, not capital gains. A life insurance policy’s proceeds received by the estate or beneficiaries or as viatical care are not taxable under the US system. However, there is a large market for investors buying someone’s life insurance policy (particularly by hedge funds); paying the future premiums and receiving the face of the policy on the insured’s demise. This has been held in the United States to be ordinary income. NZ needs to consider this behaviour and the leakage by exempting life insurance proceeds for investors.

In respect to withdrawals from retirement savings schemes, in the US retirement withdrawals from employer pension plans are treated as ordinary income. If the withdrawal is from a self-employment retirement fund, it is also ordinary income since the contributor has previously received an ordinary deduction. If the retirement withdrawal is from a Roth IRA (Individual Retirement Arrangement),\textsuperscript{91} where there is no up-front deduction, the distribution is accordingly not taxable. At present the NZ position is somewhat similar to the Roth IRA, ie, contributions into superannuation (managed) fund vehicles are made from after tax income. The income derived by a NZ managed fund is also taxable with the trade-off being the non-taxation of distributions. Depending on the activity of the managed fund, gains on the sale of investments may be income

\textsuperscript{90} Labour Party, above n 7, 9.

\textsuperscript{91} A Roth IRA is a certain type of retirement plan under US law that is generally not taxed, provided certain conditions are met. Its principal difference from most other tax advantaged retirement plans is that, rather than granting a tax break for money placed into the plan, the tax break is granted on the money withdrawn from the plan during retirement.
(unless it is a passive fund). An issue for consideration by the Expert Panel is whether such trading gains would continue to be taxable as income (typically at the corporate tax rate of 28 per cent) or at the capital gains tax rate.

3.5 Small Businesses

3.5.1 The retirement concession

The 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 (eg, 55) has held the business for 15 years and has been working in the business’. The term ‘small business’ is not defined – this and other details will be considered by the Expert Panel in consultation with the small business community. The exemption is to ensure that those who have saved through investing in a small business are not disadvantaged on their retirement. The concession will also apply to the sale of farming businesses. The United States addresses this issue with a broader exemption which allows active small business owners to exclude 50 per cent of their gain from capital gains tax, if they own the shares for more than five years. There is no age limit under the US rules. In addition, as the United States prides itself culturally as being the home of entrepreneurship, it therefore allows a deferral of the above capital gain on the sale, under Internal Revenue Code (US) section 1045, if the person invests in another qualified small business.

Example A: Joe Smith has built up his contracting corporation from scratch and put in USD 30,000 of his own funds (plus considerable amounts of ‘sweat equity’). The business is worth USD 450,000 and he sells it to a larger

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92 Labour Party, above n 7, 8.
93 Ibid 8.
94 Ibid.
95 Small business is defined (probably too generously) as an active business with less than USD 50,000,000 in gross assets.
contracting company. The USD 420,000 gain would be a capital gain but half of the gain would be excluded so he would pay USD 31,500 on his gain (USD 420,000 x ½ x 15 per cent) and have USD 418,500 for retirement. Alternatively, Joe could have purchased stock in a new business and deferred the USD 420,000 gain to the future.

Any exemption such as that proposed by Labour 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 will be required to prevent this. In addition, any threshold will require monitoring by future governments to ensure it retains its currency and the policy goals of the concession continue to be met. However, the exemption proposed by Labour is laudable and recognises the reality that NZ is a nation of small businesses and the CGT should not penalise investment and those making provision for their retirement. If the decision is made to include such a concession for small business, as in the US, the Expert Panel should also consider other forms of (small) business relief to encourage investment and innovation.

3.5.2 Small Business Losses

In the United States if a small business (defined for these purposes as less than USD 1 million of equity investment) fails, the shareholders will recognise an ordinary loss,96 rather than a capital loss, up to USD 100,000 per year.

Example B: Same facts for Joe Smith as Example A above (per Section III E Small businesses of this paper), but his business has been deteriorating due to ill health and Joe sells his shares at the bargain price of USD 10,000. The USD 20,000 loss (USD 10,000 – USD 30,000) would be treated as ordinary loss and offset accordingly.

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96 Internal Revenue Code (US) section 1244.
To recognise the risks inherent in both starting and running a business, and given the large number of small businesses in NZ, a similar rule should be considered for NZ.

### 3.6 Capital losses

#### 3.6.1 Proposed treatment

As is the practice under most CGT regimes, under the policy statement capital losses will be ‘ring fenced’ and therefore will only be able to be offset against a current or future capital gain. The Expert Panel will be tasked with deciding whether there should be an upper limit against which capital losses can be offset against capital gains or how many years to carry forward the unused loss. In the United States, there is no limit on how much capital loss may offset capital gains and a limited amount of capital losses (USD 3,000 per annum) is allowed to offset ordinary income.

Based on the proposed 15 per cent rate on capital gains, the full offset against ordinary income – which is potentially taxable at up to 33 per cent - would be very problematic. Therefore, (and subject to the potential deductibility of losses due to small business failure discussed in Section III E Small businesses of this paper) we agree with the Labour proposal that capital losses can be offset only against capital gains, and if at all, to a limited extent against ordinary income.

An issue that will also require the Expert Panels consideration is whether business trading losses will be able to be offset against capital gains. In the US, operating losses can be fully offset against capital gains, which is bad tax planning, but

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98 KPMG comment: ‘most countries limit the offset of capital losses to capital gains to manage fiscal risk … However, from a pure tax policy perspective, capital gains/losses should be treated no differently to any other gain/loss, if the objective is to tax ‘economic income’. The equity and fairness argument is somewhat reduced if losses are, effectively, not allowed’; ibid.
the correct result since the taxpayer is using a 39.6 per cent benefit against a 15 per cent cost.

### 3.6.2 Capital loss carryover

The policy statement envisages the unlimited carryover of unapplied capital losses. For individuals, the United States regime has no carryback of a capital loss and an unlimited carryover, at least until one dies (at which point the loss becomes zero).

### 3.6.3 Wash Sales

One of the more common concerns relative to capital losses is the ability to consciously time them and reduce overall tax liability without changing the economics of the investment portfolio. For example, if a person owned shares in a public company that due to market conditions had declined in value, they could sell them and repurchase the same exact number of shares shortly before or after (a wash sale) and recognise a loss which could offset capital gains and depending on the capital loss rules, ordinary income. This abuse should be prevented based on the (horizontal) equity doctrine.

*Example:* Maree owns 1,000 shares of Telecom stock with an adjusted cost basis of NZD 2,400. In November she needs some capital losses to offset recognised capital gains or ordinary income, so she sells the shares at NZD 1,300 for a loss of NZD 1,100 and buys back the stock for NZD 1,300. She has not changed her economic position (still owns 1,000 shares of Telecom) but has shielded a capital gain or ordinary income. If she doubled up on the shares right before selling, the same consequences would need to be prevented. *Internal Revenue Code* (US) section 1091 covers buying substantially identical shares or securities within a 61 day window that includes 30 days before the loss sale and 30 days after. It is considered that 30 days is enough time that the risks of the market will have to

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99 Labour Party, above n 7, 12.
be faced. Under this section Maree will not be allowed to claim the loss on the sale.

3.7 Treatment of Traders

3.7.1 The proposed approach

As indicated, s CB 5 of the Income Tax Act 2007 (NZ) provides that amounts derived by a person who is in the business of dealing in personal property are subject to the ordinary income tax rates. Taxpayers who occasionally buy and sell personal property, ie, the level of their activity means that they do not constitute dealers, are therefore not subject to ordinary income tax under s CB 5. The policy statement proposes to retain this distinction, with amounts derived by dealers (also referred to as traders) continuing to be treated as income and subject to the relevant income tax rate(s). The Expert Panel will be asked to ensure they are not taxed less than at present once a CGT is in force.

The retention of s CB 5 of the Income Tax Act 2007 (NZ) and taxation of dealers’ gains at their marginal ordinary tax rate will have two effects:

First, the preferential tax exempt treatment of non-traders selling collectables (and personal use assets), who are not currently subject to income tax and will be exempt from CGT, will encourage individuals to adopt the position that they are not dealing in the particular property. While this incentive presently exists and there is case law which considers the

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100 However, depending on their purpose at the time of acquiring personal property, the taxpayers may be subject to tax on amounts derived under s CB 4 of the Income Tax Act 2007 (NZ), even in respect of a one-off transaction. While the policy statement is silent with respect to the future status of s CB 4 of the Income Tax Act 2007 (NZ), presumably under Labour’s proposal they would be subject to CGT on any capital gains.

101 Labour Party, above n 7, 12.
characteristics of a dealer, the boundary (of what a dealer is) will come under greater pressure.¹⁰²

This obviously violates the (horizontal) equity tenet. Second, with respect to property which is not exempt, such as shares, the differential between ‘capital’ gains (subject to the CGT) and ‘revenue’ gains (taxable under s CB 5 of the Income Tax Act 2007 (NZ) at the dealer’s marginal tax rate) will create strong incentives for taxpayers to designate gains as capital rather than ordinary income and losses as ordinary rather than capital in nature. This behaviour is a complicating factor that needs to be addressed under a specific anti-avoidance provision.

In the US, dealers or developers derive ordinary income (or loss) on their trade or business activity. There are different classifications for traders, who do not rise to the level of activity of dealers, especially with outside (unrelated) people, that recognises capital gains and losses but they are permitted to deduct expenses above the line (not as an itemised deduction) and face fewer limitations than an investor. A day trader is typically in this category. The US then has the investor category that recognises capital gains and losses but is limited on deductions. Since NZ legislation and case law does not tend to distinguish between the two, the US trader and dealer categories would collapse with most of the trading activity being taxed like ordinary income given any reasonable holding period requirement.

The tax treatment of dealers/traders (and consequent issues referred to above) could be addressed to a large degree if, as already canvassed in this paper (Section III B Point of taxation), gains from assets sold within a specific period (for example 12, 18 or even 24 months) were taxable like ordinary income. Capital gains for assets held for longer than the specific holding period would be taxed at the lower CGT rate.

¹⁰² Maples, above n 11, 22.
3.7.2 Hedging transactions

One of the more complicated and problematic areas of a CGT regime are how to characterise hedging transactions. If the transaction were hedging inventory such as price of wool or milk, it should give rise to ordinary income or loss. If it is purely done as an investment, it should give rise to a capital gain or loss. However, what if a milk producer is hedging cattle prices or grain? Is that ordinary or capital in nature? Similarly to the treatment of traders, there is often a thin line between investing and business hedging and often losses will be characterised as ordinary and gains as capital in nature. This issue, which is not addressed in the policy statement, will require consideration by the Expert Panel.

3.8 Treatment of Real and Tangible Personal Property

In America, one of the complicating capital gains issues is the hybrid treatment of real estate and tangible personal property used in a trade or business. Other than land, these items are depreciated and will therefore create a larger gain. The US tax law treats the gain on sale created by depreciation deductions on tangible personal property as ordinary income (depreciation recapture is the term used in the US and depreciation recovery in NZ) and the balance as a capital gain. As NZ does not normally allow depreciation of buildings, the Expert Panel would need to consider this issue in the context of tangible personal property; in particular how to handle increases in value - as ordinary income or capital gain.

In the case of Christchurch (and surrounding areas) there may be special circumstances required due to the fact that the 2010 and 2011 Christchurch earthquakes destroyed a great deal of wealth in the region and led to the decline in underlying land values.

The policy statement proposes a different v-day for all real estate (both residential and commercial) in Canterbury to avoid additional hardship for those in the region. Recognising a
property’s value at the original v-day used for the CGT could be lower than its pre-quake levels and establishing a reliable valuation in affected parts of Canterbury could be problematic. It is proposed that real estate in greater Christchurch (as defined by the Canterbury Earthquake Recovery Act 2011) will not be liable for CGT for an initial 5 year period from the commencement of the CGT, ie, at the earliest 2018. The policy statement provides that at that point this would be reviewed and ultimately a separate Canterbury v-day for this real estate will be set.

Any time one type of asset is differentiated from another, things get considerably more complicated. We would suggest a simpler solution to this equity issue, ie, giving Christchurch taxpayers the option of using the higher of fair market value or adjusted basis for this property as of the day before the February 2011 earthquake, and the normal v-date value for everyone else.

The policy statement also provides that the v-day exemption period would also apply to insurance and other payments to compensate for the loss of real estate value that occurs after the CGT commencement.¹⁰³ For all other assets damaged in the earthquake, through the normal CGT calculation, repair costs will be offset against any capital gain.¹⁰⁴ In the US, a casualty loss on investment or trade or business property would be deductible against ordinary income and would reduce the taxpayer’s basis. Any improvements actually made would increase the taxpayer’s cost basis and unlike NZ, would be depreciable.¹⁰⁵

¹⁰³ Labour Party, above n 7, 11.
¹⁰⁴ Ibid 11.
¹⁰⁵ The impact of the earthquakes on the v-day is not included in Labour’s 2014 policy statement. Presumably the need for special treatment (and the scope of that treatment) would be determined by the Expert Panel.
3.9 Alternative Entities

As indicated NZ has a large number of family trusts. To ensure trusts cannot be used to avoid CGT the policy statement provides that the CGT will apply to capital gains derived from assets held in a trust. Transfers of assets into a trust will also generally be regarded as a CGT ‘event’.¹⁰⁶

In the United States, a trust is a taxable entity with a very low threshold (USD 13,000¹⁰⁷ vs. married couple at over USD 450,000) when it reaches the highest marginal ordinary tax rate (39.6 per cent) and therefore, they are rarely used to hold ordinary business assets. Since there is a flat 15 per cent rate on capital gains for individuals and trusts, trusts are primarily used to protect the assets for minors, persons with special needs etc. Therefore, the transfer to a trust or out of a trust is a non-taxable event.

The policy statement is silent on whether (and if so, how) the proposed CGT would apply to corporations. In the US, it technically applies to corporations but is like a vestigial organ in that it complicates the system without yielding any benefit. Corporations are subject to the same capital gains tax rules as individuals. However, unlike individuals, there is no favourable rate concession, they face a limitation on the offset of capital losses (which can only be carried back 3 years or forward 5 years) and the USD 3,000 offset of capital losses against ordinary income is not applicable.

With respect to alternative entities, the Expert Panel will be directed to consider the Australian approach.¹⁰⁸ For example, the policy statement observes that each individual within a

¹⁰⁶ Ibid.
¹⁰⁷ The 39 per cent tax rate for ordinary income of trusts applies from USD 13,000.
¹⁰⁸ Labour Party, above n 7, 14.
partnership calculates their capital gain or loss according to the portion of their legal interest in the asset.\textsuperscript{109}

In the United States, flow through entities (partnerships, LLC, LLP, S corporations, and trusts that distribute cash to its beneficiaries) will be the source of the timing and character of the capital gain or ordinary income, depending on the entity’s level of activity. The character of income (capital or ordinary) will flow through to the owner and be taxable at the owner’s level of tax. Thus, if a developer of real estate made an investment in a partnership that was investing in a commercial building being built for rental purposes as an investment, the eventual gain will be capital in nature even though at the individual level his or her activity would be ordinary in nature.

3.10 Rollover Provisions

The Expert Panel will be required to consider whether there should be any other rollover provisions in addition to those already referred to above, ie, inheritance on death and relationship breakups. The policy statement suggests rollover provisions could potentially be relevant where an asset class is transferred between taxpayer entities, for example ‘from one arm of a business to another’.\textsuperscript{110} While not entirely clear, presumably this is referring only to related party transfers. Rollover relief could potentially also apply when a taxpayer disposes of one asset and replaces it with a similar asset.\textsuperscript{111} While rollovers definitely meet the canon of convenience (of payment), they do complicate the tax system and may be viewed as violating the (horizontal) equity principle. KPMG also list as another potential area for rollover relief\textsuperscript{112} the transfer of business assets on consolidation.

\textsuperscript{109} This recognises that from a tax perspective general partnerships are transparent; s HG 2(1) Income Tax Act 2007 (NZ).
\textsuperscript{110} Labour Party, above n 7, 13.
\textsuperscript{111} Ibid 13.
\textsuperscript{112} KPMG, above n 97, 4.
In the US there are several rollover provisions which are included under the convenience principle of a good income tax despite clearly complicating the US tax law. The most common is the like-kind exchange provisions of Internal Revenue Code (US) section 1031. Assuming the exchanged assets are real estate for real estate, the exchange could include the exchange of a city parking lot for a farm and still qualify for the like-kind concession. The tax policy concept is that as there was no cashing out it would not be convenient to pay CGT thereon. However, because the US does not tax built in gains at death, nor do the heirs have an income tax liability for the appreciation prior to death, it is a massive loophole. Since it is rare to find someone that wants a person’s exact property, a three party exchange (often called a ‘Starker transaction’) is more common. Issues of mortgage relief and non-like property (called ‘boot’) will give rise to immediate gain since a cashing out has occurred to that extent.

In America, there is also a rollover (or referred to as a deferral) for involuntary conversions (earthquakes, storm damage, theft, etc.) where insurance proceeds or government payments to take property (eminent domain) are used to buy similar functioning property or a corporation that owns similar property. In the merger and acquisition area, there are complex rules dealing with when a gain is recognised or not. Several statutory, judicial, and now regulatory rules must be met to allow deferral. Among others, there is a requirement that there be a continuity of business enterprise, and that at least 40 per cent of the shareholders in the target corporation continue to own stock in the acquiring company. Also, a good corporate business purpose is required.

Example: If a shareholder has an adjusted cost basis in target stock of USD 1,200 and receives USD 2,000 in acquiring company shares and USD 200 cash, then of the realised gain of USD 1,000 [USD 2,200 – USD 1,200] on their share ownership they would recognise USD 200 of capital gain and their cost
basis in the new shares would be USD 1,200. Thus, if they were to sell the USD 2,000 value of shares, the deferred USD 800 gain would be recognised.

The US also has gain deferral where a shareholder of a company sells shares to an employee stock ownership trust (ESOP)\textsuperscript{113} or on the exchange of life insurance policies\textsuperscript{114} or shares in the same company.\textsuperscript{115}

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).’\textsuperscript{116} 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.’\textsuperscript{117} However, Cassidy and Alley sound a cautionary note with respect to rollovers and exemptions generally:

> Political pressures often see such CGT carve-outs and preferences increase over time; sometimes to the extent that the tax effectively implodes.\textsuperscript{118} Thus care must be taken when introducing concessions lest they erode the benefits of a CGT. These carve-outs and preferences undermine the neutrality of the taxation regime\textsuperscript{119} and necessitate the introduction of anti-avoidance measures which add to complexity of the provisions. Again equity is undermined as it is wealthier New Zealanders who benefit from these carve-outs and preferences.

\textsuperscript{113} Under Internal Revenue Code (US) section 1042, in which a shareholder can rollover the sales proceeds into publicly traded shares and if they hold the investment until they die, no gain will be recognised.

\textsuperscript{114} Internal Revenue Code (US) section 1035.

\textsuperscript{115} Internal Revenue Code (US) section 1036.

\textsuperscript{116} Evans and Sandford, above n 2, 404.

\textsuperscript{117} Ibid 404.

\textsuperscript{118} Tax Review 2001, Final Report (Wellington, 12 October 2001), 34.

Zealanders who have the ability to restructure their affairs and invest in tax-free capital assets.\textsuperscript{120}

An example of potential abuse whether or not utilising rollovers is the ‘cheap step up in cost basis’ technique. If a transfer is made to an existing or new partnership or corporation, then if a capital gain is recognised at a 15 per cent rate and the business can depreciate the asset at a 39 per cent rate, an unwelcome arbitrage has been created. In the United States, \textit{Internal Revenue Code} (US) sections 1239 and 707 are intended to prevent this technique but if less than 50 per cent ownership is involved, it still may be effective.

\textit{Example}: Assume Andrea owns 48 per cent of XYZ Corporation and her cousin owns 47 per cent and unrelated people own the other 5 per cent. All three transfer property to the entity among which Andrea transfers plant and equipment to XYZ Corporation with a large built in gain and receives USD 300,000 cash, Andrea will recognise USD 300,000 capital gain, taxable at 15 per cent and the partnership will increase the basis USD 300,000. The extra depreciation would give a benefit at the 35 per cent tax rate for an arbitrage of 20 per cent on the transaction.

If in the above example, Andrea owned more than 50 per cent, then Andrea’s gain would have been converted into ordinary income and a negative arbitrage would have resulted in that she would have USD 300,000 ordinary income at 39.6 per cent and the corporation would have an extra deduction at 35 per cent.

3.11 Venture Capital

The policy statement observes that venture capital investment is exempt for foreign residents from CGT in Australia.\textsuperscript{121} However, residents would be subject to tax on the

\textsuperscript{120} Cassidy and Alley, above n 43, 99.
\textsuperscript{121} Labour Party, above n 7, 13.
investment earnings. Accordingly, the Expert Panel will be required to consider whether a similar exemption apply in NZ to avoid a Trans-Tasman tax differential, or to ensure simplicity, asset neutrality and anti-avoidance venture capital should be treated no differently to other investments.\textsuperscript{122}

In the US venture capital, hedge funds and private equity funds are typically formed as partnerships. United States citizens or residents are subject to tax on their share of partnership earnings and much of those earnings are dividends or capital gains in a nature, and they are taxed as such. Most non-resident investors are exempt from US taxation on these earnings. The compensation of the managing member or general partners, called ‘carried interest’ is subject to continuing heated debate.\textsuperscript{123} It is presently characterised as capital gain income, but most commentators, the Camp proposed (US) \textit{Tax Reform Act of 2014} and President Obama’s recent tax proposal all propose taxing it as ordinary service income. Thus, on a horizontal equity basis, there seems no reason that a managing member’s labour income should be taxed at favourable capital gains rates while a professor, contractor or investment banker should be taxed at ordinary income rates.

3.12 Comments and Recommendations

We conclude this section with certain key recommendations and observations from the preceding discussion.

3.12.1 Capital gains rate

We agree with the suggested 15 per cent CGT rate on gains with no indexation for inflation. The US rejected indexing for

\textsuperscript{122} Ibid 13.
\textsuperscript{123} Typically, a managing member will be entitled to 20 per cent of the profit from the sale of a business for the work they did on investigating hundreds of potential investments. This is called carried interest and might be likened to an attorney who does work on a contingent basis. If the client wins, the attorney typically receives 1/3 to 40 per cent of the award. This is clearly classified as ordinary income.
inflation as was considered too complex to implement especially since different assets appreciate at very different rates. Also, since NZ does not allow depreciation on 50 year assets (real estate), arguably (at least in respect of real estate) appreciation will be more likely to be real and worthy of taxation at capital gain rates.

The next question is whether the CGT regime include an annual exemption for individuals? Evans and Sandford recommend a tax-free threshold for individuals on the basis that it ‘has the advantage of significantly reducing the operating (administration and compliance) costs related to the CGT, by eliminating the “minnows and tiddlers” from the CGT net, without impugning the overall integrity of the regime.’\(^\text{124}\) As discussed the US does have a provision for eliminating these ‘minnows and tiddlers’\(^\text{125}\) and to reduce equity (and complexity) concerns arising from Labour’s proposal we similarly recommend a zero rate on lower income earners capital gains, for example for income up to NZD 48,000 (the second income bracket).

Contrary to the policy statement, and also on the basis of equity, we recommend a capital gains rate for collectables (rather than exempting these items).

3.12.2 Point of taxation and valuation day

From a practical perspective, the CGT would be imposed on realisation and, to minimise lock-in (and consequent complexity concerns) of pre-CGT assets, it would apply from a specific valuation date and to both sale and exchange transactions. With respect to assets whose v-day value is below their purchase price, the US treatment for gifted assets (ie, the median approach) would seem appropriate. In the case of the Christchurch earthquakes, rather than postponing the v-date

\(\text{124}\) Evans and Sandford, above n 22, 404.

\(\text{125}\) A zero tax rate exists for individuals with low net ordinary taxable income (below USD 70,000 for married and USD 35,000 for single).
(which will lead to behavioural responses) alternative options for valuing earthquake damaged property should permitted.

3.12.3 Exemptions and rollover provisions

We acknowledge from a political perspective the main residence must be excluded from the CGT. However, unlike the Labour proposal we believe it should be capped to minimise the revenue leakage apparent in countries like Australia where a full exemption exists. The exemption could include a similar rule to that adopted in the US where a waiting period exists, for example a five out of eight year period to limit some gaming that arises from the exemption. The main residence exemption should also extend to houses owned by trusts, given the widespread use in NZ of this vehicle for home ownership (but with specific anti-avoidance rules as necessary).

We prefer the stance of the policy statement with respect to the deferral of capital gains on inheritance to the US approach where such gains disappear on death. While this would violate equity it would reduce the major lock-in effect which is a feature of the US approach and satisfy Smith’s convenience criteria. An alternative approach would be for CGT to be triggered on death with an extended payment schedule to reduce problems of funding the tax and to encourage gifting. This treatment applies now in the US in the context of estate tax. If a significant portion of a person’s estate (35 per cent) is related to a closely held business or a farm, then Internal Revenue Code (US) section 6166 allows a deferred payment plan over between 10 and 15 years to pay the estate tax. This would be consistent with Smith’s convenience of payment tenet.

Also on the basis of the convenience of payment principle there is scope for a range of other limited rollovers or deferrals of CGT, for example on legal separation or divorce (as proposed by Labour) and on like-kind exchanges. Similarly, rollover should apply to involuntary conversions (earthquakes, storm damage, theft, etc) where insurance proceeds or government
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payments to take property are used to buy similar functioning property or a corporation that owns similar property.

As a general observation we recommend that exemptions from the CGT provisions and deferral be limited due to complexity and revenue impact considerations.

3.12.4 Small businesses

Rather than a narrowly targeted exemption (as proposed by Labour) we recommend adopting the US approach of allowing active small business owners to exclude 50 per cent of gains from capital gains tax, if they have owned the business (eg, shares) for more than five (5) years. This encourages investment (and reinvestment) in businesses and is not limited by age.

To recognise the risk aspects of operating (small) businesses and to encourage entrepreneurship, if a small business (as defined up to a certain amount of equity investment) fails, the shareholders should be allowed to recognise any losses as an ordinary loss, rather than capital loss, up to a pre-determined level per year.

3.12.5 Losses

We agree with the Labour proposal that capital losses be able to be offset against current and future capital gains only, but essentially as a concession to smaller investors would recommend capital losses to a limited extent (eg, NZD 3,000 per annum) could be offset against ordinary income.

3.12.6 Traders

The different treatment proposed by Labour for traders will put pressure on the definition of the term and require a very robust specific anti-avoidance rule. Our preference would be to instead repeal s CB 5 Income Tax Act 2007 and follow the US approach of differentiating between short term gains (subject to tax as ordinary income) and longer term gains. This would reduce the complexity that will arise from determining who is
and is not a trader and the arbitrage opportunities that arise accordingly.

3.12.7 Alternative entities

Adopting the US approach, (and consistent with the current NZ income tax treatment), any capital gains (or losses) derived by flow through vehicles (partnerships, limited partnerships) and trusts (with respect to distributions to beneficiaries) will flow through to the owner and be taxable at the owner’s level of tax. To simplify the tax it should not apply to corporations.

4. Further Issues for Labour to Ponder

If the decision is made to implement a CGT there are a number of additional issues that will require consideration by policymakers, including but not limited to:

(1) As previously noted, while NZ does not have a comprehensive CGT regime, it does have ‘a multitude of different CGT’s embedded in the tax rules’\textsuperscript{126} including section CB 3\textsuperscript{127} which bring to tax certain gains from the sale of personal property as well as the financial arrangements regime and offshore foreign investment fund (FIF) rules, both of which tax capital gains on an accrued basis. The introduction of a comprehensive CGT regime will bring ‘the need for the retention of ‘micro regimes’ such as the FDR [Fair Dividend Rate]\textsuperscript{128} is brought starkly into focus, with the potential for such to be eventually removed from the

\textsuperscript{126} Patrick McCalman, \textit{A 10-step Guide to a Potential Capital Gains Tax}, Deloitte (online) (New Zealand), undated, 1.

\textsuperscript{127} Section CB 3 provides that an amount a person derives from carrying on an undertaking or scheme entered into or devised for the purpose of making a profit is income of the person.

\textsuperscript{128} The FDR method can be used by taxpayers to calculate their income from FIFs. Under this method, the taxpayer is taxed on 5% of the opening market value of all their attributing interests in offshore investments (FIFs).
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It remains to be seen to what extent the current ‘micro’ CGT regimes are removed. As noted, unfortunately, at least with respect to section CB 5, which taxes the income of dealers, it appears that provision will run in parallel with the CGT meaning the current problematic boundary issue of what is dealing remains.

(2) Labour’s policy does not indicate whether a distinction will be made between short term and long term gains, for example by tapering relief. As noted, the United States does differentiate between short and long term gains by providing that gains from the sale of short term assets (i.e., assets sold within one year or in the case of livestock or horses two years) are treated as ordinary income. This view is contrary to Evans and Sandford who, to maintain equity and efficiency considerations, strongly argue for minimising all preferences and concessional treatments including any distinction between short term and long term gain:

as different treatment of such gains causes difficulties at the margin, encourages the ‘lock-in’ effect, significantly adds to the complexity of the regime and undermines the fundamental principle

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129 McCalman, above n 126, 1.
130 Tapering relief reduces the percentage of the capital gain that is chargeable with CGT for assets held for a longer period. In Australia, for example, a 50 per cent discount on capital gains is available in some cases to individuals and certain trusts for assets held for more than 12 months; Chris Evans, ‘Taxing Capital Gains: One Step Forwards or Two Steps Back?’ (2002) 5 Journal of Australian Taxation 114, 124, 127; Cassidy and Alley, above n 43, 119. Evans is highly critical of the 50 per cent discount arguing it: ‘savagely offends both the horizontal and vertical aspects of equity’; Evans, above n 130, 127. Such a discount clearly favours the wealthy with high marginal tax rates and for this reason where possible such relief should be provided by way of a special rate.
that all gains are income and should be treated as such.\textsuperscript{131}

The treatment adopted in this respect will require policymakers to weigh up competing principles (for example convenience and complexity).

(3) Is the CGT a separate tax or part of the income tax code? Cassidy and Alley suggest it is likely that Labour’s CGT would be integrated into the existing income tax legislation, the \textit{Income Tax Act 2007} (NZ) – the approach has been adopted in United States (along with Australia and South Africa).\textsuperscript{132} It has considerable tax benefits for the revenue authority and taxpayers as the CGT forms part of the existing tax administration system.\textsuperscript{133} From a practical perspective any CGT regime will need to be supported by Inland Revenue’s software systems. In respect of the introduction of a CGT in NZ, at present, it is suggested that ‘until Inland Revenue’s first mainframe computer system is finally upgraded, such a significant policy change would likely be the last straw to a full collapse of the current computer system.’\textsuperscript{134} Inland Revenue are in the early stages of commissioning a new computer system.

(4) A related issue to (3) above is the extent to which the enacting capital gains legislation relies on specific anti-avoidance rules (SAARs) or more generally, s BG 1 of the \textit{Income Tax Act 2007} (NZ) (the GAAR). A greater reliance on SAARs may provide more certainty for taxpayers but at the expense of increased length and potential complexity of the CGT rules. It is also worth noting when considering the US

\textsuperscript{131} Evans and Sandford, above n 22, 404.
\textsuperscript{132} Cassidy and Alley, above n 43, 99.
\textsuperscript{133} Ibid 99.
\textsuperscript{134} Greg Thompson, ‘Budget 2014: Why a Capital Gains Tax will be off the Agenda’ \textit{The National Business Review} (online) (Auckland), 13 May 2014, 1.
CGT that the structure of their capital gains tax provisions reflect the fact that there is no US GAAR (and hence there is potentially a greater reliance on SAARs as a consequence).

(5) The policy statement is silent on the CGT treatment of a wide range of transactions. The Expert Panel will need to review other CGT regimes (such as the US) to identify potential issues, in addition to those already highlighted, that require its consideration. Drawing from the US, two examples come to mind. First, a CGT regime introduces an issue concerning the taxation of interest income. Interest income is subject to ordinary income rates. However, if a corporation issues a bond at a discount, whether the increase in value is a capital gain or ordinary income is a very relevant issue. Example: A bank issues debt instruments with a USD 1 million principal amount at 8 per cent due in 9 years. The bank accepts USD 500,000 for its USD 1 million face amount, but agrees no interest is due. Is the accretion in value ordinary income or capital gains? In the US this would be considered original issue discount and thus ordinary interest income. This is clearly an application of the horizontal equity doctrine.

Second, the newest ‘wrinkle’ as to what is capital gain income or ordinary income is the tax treatment of bitcoins. The Internal Revenue Service (IRS), in Notice 2014-21, presented how to treat these new intangibles. The IRS made it clear that they are not a foreign currency since no government has issued them. They will be treated just like any property. Therefore, if a taxpayer receives bitcoins for solving computer problems (called mining), they will generate ordinary income. If they pay salary with this virtual currency, they will get a deduction at the fair market value of the property at the date of payment. If they had a lower
basis in the currency than its value, then they could have a capital gain on the exchange of the asset.

5. CONCLUSION

The introduction of a CGT in NZ is now arguably part of the political agenda of the left-of-centre parties in NZ. It is therefore only a matter of time – the next General Election is in 2017 - before this political grouping secure the necessary seats to govern. Learning from the pitfalls, strengths and weaknesses of CGTs implemented in other countries is in tune with NZ’s approach of considering both administration and compliance issues, convenience of payment and equity issues in crafting its tax laws, while conforming to its unique cultural attributes. We hope this paper will contribute to that effort.

The policy statement has been well researched; it is informative and clearly illustrates the application of the proposed CGT. However, not unexpectedly, as a statement prepared for a general election it lacks some detail which limits a comprehensive analysis and also raises a number of issues for further consideration. These include whether there should be a distinction between short and long term gains. In addition, officials will need to consider how the CGT will interact with existing regimes which effectively tax specific capital gains and whether these ‘micro’ CGT regimes are removed or modified.

In many respects Labour appears to be proposing a fairly ‘standard’ CGT – it is a realisation-based CGT which exempts the family home and quarantines capital losses. Certain behavioural responses can be expected; including the mansion effect, the lock-in of assets and pressure on the definition of the term ‘dealer’.

The overarching policy underpinning the design of the NZ tax system is that it should have a broad-based low rate tax
Ideally a CGT should complement this approach. The challenge for those designing the CGT will be to manage the trade-off between principles of a good tax such as equity, convenience and efficiency. It is clear from a consideration of the US (or any other) CGT regime that it introduces significant additional complexity into the tax system. Some of this complexity may be as a result of policymakers pursuing equitable principles within the CGT, for example by introducing specific concessions. While we believe exemptions and concessions should be minimised, there is a strong argument for some relief such as a tax free threshold in order to reduce compliance and administrative costs.

On the basis that a CGT is now firmly established as a policy of the left-of-centre parties, it would be unfortunate if the debate for a CGT in a future General Election was overtaken by election rhetoric and hype and for the principles of a good tax to be buried under a sea of compromise. Such a concern is not unfounded: ‘[a CGT] is a compromise, and, as is so often the case with a compromise, it functions badly and pleases no one.’

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; ‘A failure to clearly articulate its purpose and adhere to it will potentially lead to a poorly designed and functioning CGT.’ To this end some have questioned Labour’s motivation for proposing the tax. For example, Thompson comments ‘From a Labour perspective … Despite not publicly stating this, CGT is a socialist tax that aims to tax the wealthy who own capital assets.’ One of the key

135 Inland Revenue Department, *Briefing for the Incoming Minister of Revenue - 2013* (Inland Revenue Department, Wellington, June 2013).
137 Maples, above n 11, 31.
138 Thompson, above 134, 1.
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.’\(^{139}\)

At present the OECD estimates that NZ ‘house prices are 66 per cent overvalued based on the long-run average ratio of house prices to rents, making them the most overvalued among 31 developed countries.’\(^{140}\) The causes of this are various including lack of supply, rising building costs and increasing immigration into NZ. The impact the introduction of a CGT would have on house inflation is unclear and hotly debated.\(^{141}\)

Policymakers and officials can expect to face heavy lobbying from sector groups when a CGT finally receives the ‘go ahead’. Keeping a clear focus of the object(s) of the CGT and the principles of a good tax should ensure that lobby group pressure does not derail the tax.

Finally, NZ 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 US. In the event that NZ does

\(^{139}\) Labour, above n 7, 15.

\(^{140}\) Brian Fallow, ‘Support for Capital Gains Tax’ *The New Zealand Herald* (online) (Auckland), 20 May 2014, 1.

\(^{141}\) The Prime Minister John Key, who opposes a CGT, is quick to point out that countries with a CGT have still suffered from house price inflation; Fox, above n 5, A5. Hosking also comments that ‘There is no reason to think a capital gains tax would stop any future property bubble: it certainly didn’t in Australia or the United States’; Rob Hosking ‘Capital gains taxes: myths, misconceptions and lies’ *The National Business Review* (online) (New Zealand), 15 April 2013, 2. The NZ Treasury in fact suggest a CGT could cause real property process to be lower; The Treasury, above n 42, 48. Interestingly, UK finance minister George Osborne has announced that from 2015 Britain will impose CGT on foreign investors selling homes that are not their primary residence to curb soaring house prices: ‘Britain to tax foreign property investors from 2015 – Osborne’ *Reuters.com* (online), 5 December 2013). Westpac chief economist, Dominick Stephens believes a ‘15 per cent capital gains tax would reduce the value to an investor of a given property by 23% if rents remain unchanged … My view is that upon the introduction of a capital gains tax house prices could well fall, so long as other house conditions weren’t conducive to rapid house price increases’; Fallow, above n 140.
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ultimately progress down the path of implementing a CGT it is therefore hoped that NZ maximises this opportunity to draw on overseas experiences.