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The Relationship Between Principles and Policy in Tax Administration: Lessons from the United Kingdom Capital Gains Tax Regime with Particular Reference to a Proposal for a Capital Gains Tax for New Zealand

Simon James
Associate Professor of Economics
University of Exeter Business School

Andrew Maples (contact author)
Associate Professor of Taxation
University of Canterbury

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Simon James* and Andrew Maples$^{\lambda}$

Abstract

It is unusual to find a tax in operation which does not represent a compromise between tax principles, policy and administrative considerations. However, the third of these, tax administration, often does not receive the attention it should as proposals for tax reform are developed. This paper examines one particular case, the possibility that attempts to introduce a capital gains tax (CGT) in New Zealand have been unsuccessful because the right balance between the three dimensions of tax reform has not been achieved and that for this and other possible reforms each of these aspects should be given the appropriate consideration. New Zealand (NZ) does not currently have a comprehensive CGT. In fact, political commentators have long said that the enactment of a CGT in New Zealand would be political suicide. The reasons for such antipathy towards a CGT are not entirely clear especially given the successful implementation and operation of capital gains tax in many jurisdictions, including the UK. However, sentiment towards a CGT in NZ appears to have softened more recently. Perhaps sensing this rise in support, the centre-left New Zealand Labour Party in the 2011 and 2014 General Elections unsuccessfully campaigned on *inter alia* introducing a comprehensive CGT. It is unclear what part the CGT proposal played in its defeat in both elections with other factors in play. However, noting that the CGT policy may have alienated voters in the 2014 election, Labour Party leader, Mr Andrew Little has indicated that reform of the NZ tax system, including a possible CGT, would not be made "without going to the people first and getting a mandate to do so" (NBR online ed, 7 November 2015). Accordingly, the electorate support for a

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* Simon James is an Associate Professor of Economics at the University of Exeter Business School, a Fellow of the Chartered Institute of Taxation and an Honorable Member of the Society for the Advancement of Behavioral Economics. He has held visiting positions at six universities overseas, published many research papers and his 16 books include a four volume edited collection of papers *Taxation: Critical Perspectives on the World Economy,* 2002, *A Dictionary of Taxation,* 2nd edition 2012, *The Economics of Taxation: Principles, Policy and Practice* (with Chris Nobes) 15th edition 2015 and, jointly edited with Adrian Sawyer and Tamer Budak, *The Complexity of Tax Simplification: Experiences from around the World*, 2016.

$^{\lambda}$ Andrew Maples is an Associate Professor of Taxation in the School of Business and Economics at the University of Canterbury. He is widely published with articles in a number of scholarly journals including the *British Tax Review*, *Australian Tax Forum*, and the *New Zealand Journal of Taxation Law and Policy*. Andrew is founding author of Thomson Reuters *New Zealand Taxation – Principles, Cases and Question,* now in its 13th edition. He is on the advisory board on the *New Zealand Journal of Taxation Law and Policy* and editorial board of the *Journal of Australian Taxation*.

CGT, and its design (including the administration of the tax), will be crucial for its political viability in NZ; hence the rationale for this paper. The paper finds that the UK capital gains tax is a very robust tax but has never taken a pure form based only on the principles of good tax design. Indeed its success in tax policy terms has been largely accounted for by pragmatic modifications over the years to accommodate the different and changing political and economic pressures applying to modern tax systems. The paper concludes that a more pragmatic approach could lead to the design of a capital gains tax that may gain the broad support of the NZ electorate and also be as successful and enduring as it has been in the UK.

Note this paper is part of ongoing research.

1. INTRODUCTION

It has been suggested that tax administration has not been given sufficient attention in the voluminous literature on tax reform[1] although its importance is clear and acknowledged, for instance, in their part of the Mirrlees Review[2] by Shaw et al. who stated: “administration and enforcement are often neglected in tax policy, but they are central to making a tax system work”.[3] Tax Administration covers a range of aspects of taxation. One view seems to be tax administration is concerned only with the implementation, management and enforcement of existing tax legislation and other regulations. However, some authorities have taken a wider view. For example, Gordon’s analysis[4] is developed in terms of the law of tax administration and procedure and tax administration has also been used to include the development and formulation of tax policy relating to tax legislation and related regulations.[5]

In developing tax design the natural place to begin is with tax policy as it reflects government aims and objectives but these should take into account tax principles and practice in the form of tax administration. Although tax principles are a valuable guide to tax design, the optimal outcome might require modification in the light of tax policy and the reality of tax administration. As already indicated, tax administration should also be considered but administrative solutions should take account of both policy and principles. Figure 1 illustrates the view that all three dimensions interact and each should take account of the other two.[6]

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[1] See, eg, Richard M Bird, ‘Administrative Constraints on Tax Policy’ in Cedric Sandford (ed), *Further Key Issues in Tax Reform* (Fiscal Publications, 1998).

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

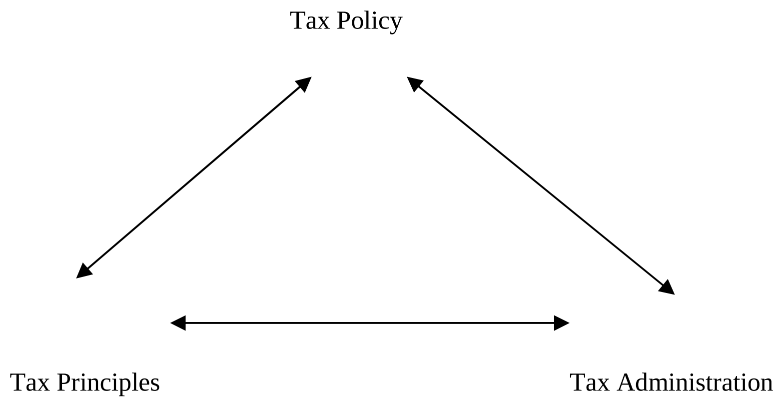
[3] Jonathan Shaw, Joel Slemrod and John Whiting, ‘Administration and compliance’ in Sir James Mirrlees (Chair), *Dimensions of Tax Design: The Mirrlees Review* (Oxford University Press, 2010) 1100-1162.

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

[5] US Legal, definition available at: <http://definitions.uslegal.com/t/tax-administration/>.

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

Figure 1 The Interdependence of Tax Policy, Principles and Administration



This paper examines the view that successful tax reform requires an appropriate balance between tax principles, policy and tax administration. The paper uses as a case study a comparison of the UK experience of capital gains tax over a period of fifty years, which has involved a considerable degree of interaction between the three dimensions, with recent proposals for the introduction of a capital gains tax in NZ.

To set the context for this paper, New Zealand (NZ) operates a broad-base, low rate (BBLR) tax system, which includes an income tax for individuals with four tax rates (and a low top tax rate of 33%),[7] and a comprehensive goods and services tax (GST).[8] However, the country is unusual among Organisation for Economic Development and Cooperation (OECD) countries as it does not have a comprehensive capital gains tax (CGT). Rather, certain specified capital gains are taxed in the *Income Tax Act 2007* (NZ). Despite various committees considering the implementation of a CGT in New Zealand, admittedly with differing conclusions, and overseas bodies such as the OECD[9] noting the benefits of a CGT for the NZ economy, there has been a longstanding antipathy against adopting the tax. While sentiment may have softened among some business leaders and

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[7] Perhaps unusually compared with countries such as the UK and Australia there is no tax-free threshold.
[8] NZ does not have (i) an inheritance tax, (ii) local or state taxes apart from property rates levied by local councils and authorities, (iii) a payroll tax, (iv) social security tax, or (v) a health care tax, apart from a very low levy for New Zealand's accident compensation injury insurance scheme.
[9] 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 framework and stated that a CGT could, along with other tax changes, 'facilitate a more efficient and equitable tax structure'; OECD, *OECD Economic Surveys: New Zealand* (OECD Publishing, 2013) 24.

politicians,[10] more will be required in order for any proposal for a CGT to be supported by the electorate.

The remainder of this paper is structured as follows: Section 2 considers, by way of background, the possible reasons for the hostility towards a CGT in NZ and recent moves to the New Zealand Labour Party (Labour) to promote such a tax. Section 3 provides an overview of the UK's experience with a CGT. Section 4 outlines and critiques key aspects of Labour's CGT policy set against the UK experience and in the context of the strength of feeling against a NZ CGT. Concluding comments and observation are made in Section 5.

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

2.1 Why the Angst?

As indicated in Section 1.0, NZ has adopted a BBLR tax framework; one that politicians and policymakers are quick to extol.[11] However, claims that without a CGT New Zealand is operating under such a framework must therefore be questioned. While the arguments in support of a CGT in NZ (such as equity[12] and neutrality)[13] have been well canvassed; the flaws in the current income tax system absent such a tax are acknowledged,[14] and

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[10] See, eg, Ben Chapman-Smith, 'Capital gains tax no good unless comprehensive – English', *The New Zealand Herald* (online), 25 July 2013; Thomas Pippos, 'Capital gains tax an inevitable part of the future landscape', *The New Zealand Herald* (online), 23 July 2013; Jamie Gray, 'Labour's tax plan centre stage for our CEO's', *The New Zealand Herald* (Auckland), 12 September 2014 <www.nzherald.co.nz/mood-of-the-boardroom/news/print.cfm?objectid=11322939>.

[11] See, eg, Hon Todd McClay, 'Speech to Chartered Accountants Australia and New Zealand tax conference' <http://taxpolicy.ird.govt.nz/news/2014-10-31-address-caanz-tax-conference#speech>.

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

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

[14] See, eg, Craig Elliffe, 'Building a Better Bridge: The Case for Taxing Capital Gains in New Zealand' (2010) 16 NZBLQ 178.

some review committees have recommended the implementation of a CGT in NZ,[15] it has been a long held belief in NZ that the enactment of a comprehensive CGT would be "[a] sure-fire path to political suicide".[16] Former Prime Minister, the Rt Hon David Lange reputedly characterised "a capital gains tax policy as one likely to lose you not merely the next election, but the next three".[17]

The strength of feeling against a CGT is curious to those outside NZ, including one of the authors of this paper, given that CGTs have been implemented successfully around the world, including the UK and, more recently, South Africa (in 2001). An understanding of this issue, and the whether the proposals contain the right balance between policy, principles and administration, may aid in the development of a CGT policy in NZ

At first sight, one of the difficulties with the proposals considering the introduction of a CGT in NZ is that administrative issues have been insufficiently addressed. Of the various review committees in NZ that have considered and rejected suggestions of a CGT, the primary reasons offered include its complexity, that it would produce little revenue and an accruals-based CGT would be infeasible.[18] Huang and Elliffe posit that:[19]

> The reason historically that New Zealand does not have a CGT is not because New Zealand policymakers fail to recognise the benefits of such a form of taxation, but because they have been overawed by the perceived problems and cost associated with it. In looking at the history of this tax policy, it is possible to conclude that the rejection

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

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

[17] 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.

[18] For the history of the CGT debate, including the findings of previous committees which have looked into a CGT for New Zealand, see further Chye-Ching Huang and Craig Elliffe, 'Is New Zealand Smarter than Other Countries or Simply Special? Reconsidering a Realisation-based Capital Gains Tax in the Light of South Africa's Experience' (2010) 16 *New Zealand Journal of Taxation Law and Policy* 269, 274-279; Julie Cassidy and Clinton Alley, 'Capital Gains Tax: Lessons From Across the Ditch' (2012) 18 NZBLQ 97, 97, 100-105, and Shelley Griffiths, 'The Game is Not Worth the Candle': Exploring the Lack of a Comprehensive Capital Gains Tax in New Zealand' (2015) 21 *New Zealand Journal of Taxation Law and Policy* 51.

[19] Chye-Ching Huang and Craig Elliffe, above n 18, 304. Emphasis added

> is primarily due to unsubstantiated assertions that the law will become *too complex from an administrative and technical perspective*, and, bearing this burden in mind, is not worth the trouble from the revenue-collection perspective.

Considering the various NZ government reviews of CGT, Huang and Elliffe conclude that "in deciding against adopting a CGT, New Zealand governments have not carefully and explicitly considered the experience of other jurisdictions".[20]

Griffiths more cautiously observes that: "It is … true that it is difficult to discern why New Zealand has almost uniquely chosen to not enact an overt CGT."[21] In her review of the NZ tax system since the introduction of income tax in 1891, she suggests hostility to a CGT is "no historical accident"[22] observing:[23]

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

New Zealand's experience with another new form of taxation – the goods and services tax – has been very positive[24]partly because it did not face serious administrative concerns. The emphasis of the policy design of the GST strongly focussed on simplicity with equity concerns being dealt with outside the GST itself (via the welfare transfer system).[25] As a consequence the GST is economically very efficient. This positive experience with a comparatively "pure" tax, with its few exemptions, may have negatively impacted on perceptions of, and support for, a CGT. Griffiths observes: "… the experience with a very broadly based and successful goods and services tax has meant there has been a reluctance to settle for what seems like a CGT complicated by exceptions and

[20] Ibid 273.
[21] Griffiths, above n 18.
[22] Ibid 68.
[23] Ibid. Griffiths notes for example: "In 1922 and 1924, two general reports on taxation in New Zealand highlighted the need for the tax system not to discourage the disaggregation and growth of capital.": at 68.
[24] Hon Sir Roger Douglas, 'The New Zealand GST Policy Choice and its Political Implications' in Richard Krever and David White (eds), *GST in Retrospect and Prospect* (Brookers Ltd, 2007) 3.
[25] Equity concerns (including the impact of regressivity) were dealt with in a parallel system offering benefits and incentives for lower income taxpayers and families: Ibid 6.

imperfections."[26] The very success of one significant tax reform perversely may hinder the support for, and implementation, of another major tax reform – a CGT.

2.2 A Change in the Mood?

Sentiment towards a CGT in NZ has softened more recently with a number of commentators as well as business and political leaders supporting (or acknowledging the need for) the introduction of a CGT.[27] Backing for a CGT has also been evident among the wider community,[28] although it is arguably "not [yet] … to the level of popular support."[29]

Perhaps sensing this change in the mood towards a comprehensive CGT, the centre-left New Zealand Labour Party in the 2011 and 2014 General Elections unsuccessfully campaigned on *inter alia* introducing a comprehensive CGT levied at a flat rate of 15 per cent. It is unclear what part the CGT proposal played in its defeat in both elections[30] with other factors in play, including (especially in 2014) an economy experiencing very strong growth. However, noting that the CGT policy may have alienated voters in the 2014 election, Labour Party leader, Mr Andrew Little has indicated that reform of the NZ tax system, including a possible CGT, would not be made "without going to the people first and getting a mandate to do so".[31]

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[26] Griffiths, above n 18, 68.

[27] See, eg, Ben Chapman-Smith, 'Capital gains tax no good unless comprehensive – English', *The New Zealand Herald* (online), 25 July 2013; Thomas Pippos, 'Capital gains tax an inevitable part of the future landscape; *The New Zealand Herald* (online), 23 July 2013; Jamie Gray, 'Labour's tax plan centre stage for our CEO's', *The New Zealand Herald* (Auckland), 12 September 2014 <www.nzherald.co.nz/mood-of-the-boardroom/news/print.cfm?objectid=11322939>.

[28] A poll by Fairfax Media-Ipsos undertaken in October 2013 found 52.3 per cent believed a CGT on investment properties would help control rising house prices, up from 37.1 per cent in an August poll (although not stated, presumably also conducted by Fairfax Media-Ipsos).: Michael Fox, 'Kiwis 'ready' for capital gains tax', *The Press* (Christchurch), 12 November 2013, A5.

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

[30] On the role of the CGT policy in Labour's 2011 election defeat, political commentator Colin James observes: "Whether the capital gains tax was the cause, or just opened the trapdoor through which Labour was destined to fall, is debateable. Judging by subsequent ratings in the polls, I think it was probably the latter.": Colin James, 'On a Wing and a Smile: Political Transition in National's Business-as-Usual Re-Election' in Jon Johansson and Stephen Levine (eds), *Kicking the Tyres: The New Zealand General Election and Electoral Referendum of 2011* (Victoria University Press, 2012) 65, 66 as cited in Barrett and Veal, above n 17, 94, n 28.

[31] 'Little, Robertson confirm Labour's ditched policies and reveal some new ones', *NBR* (online), 7 November 2015 <http://www.nbr.co.nz/article/little-robertson-confirm-labours-ditched-policies-and-reveal-

Labour's 2011 CGT proposal[32] was retained essentially unchanged as part of its 2014 tax policy.[33] The two policy statements are referred to in this paper as the "2011 policy statement" and "2014 policy statement". This paper primarily focusses on the 2014 policy statement as it reflects the most recent iteration of Labour's CGT policy.

At the 2011 and 2014 General Elections, the policies of the left-of-centre Green Party of Aotearoa New Zealand (Greens)[34] and the smaller Mana Party[35] also included the introduction of a CGT in NZ. On the basis that the Mixed Member Proportional (MMP) electoral system produces coalition-based governments and the Greens and Labour (at least) are likely coalition partners in a future government, a CGT in New Zealand is a distinct possibility in the medium term. Pressure on the fiscal purse from an aging population will also necessitate the exploration for alternative revenue sources (such as a CGT) for future governments.[36] However, presently NZ is in a unique position. The country is not in the dire economic position it was in 1984[37] when the incoming Labour government, led by Rt Hon David Lange, was forced to undertake major structural changes to the tax system within a short period (including the introduction of the good and services tax). The country has weathered the 2008 global financial crisis comparatively well.[38] Major structural tax reform, such as the introduction of a CGT, at this time is not pressing. Further, as a late adopter of a CGT it has the advantage that it can look to the practices of other jurisdictions including the UK. Accordingly, it is timely

some-new-ones-ng-181292?utm_source=newsletter&utm_medium=email&utm_campaign=NBR%2520Heads%2520Up>

[32] Labour Party, "Labour's Fairer Tax System Explained …" <www.labour.org.nz/sites/default/files/CGTWebdoct%20July%202011.pdf>.

[33] Labour Party, "Capital Gains Tax" <www.labour.org.nz/sites/default/files/issues/capital_gains_tax.pdf>.

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

[35] The Mana Party campaigned on the introducing a CGT on all assets except the family home and Maori land, see, eg, <mana.net.nz/policy/policy-economic-justice/>.

[36] In its briefing to the Minister of Finance, Inland Revenue noted in the context of broadening the tax base: "The largest area of non-taxation of income in New Zealand that could practically be taxed is capital gains.": Inland Revenue, *Briefing for the Incoming Minister of Revenue – 2014* (Wellington, 12 November 2014) <www.ird.govt.nz/aboutir/reports/briefing/briefing-2014/bim-14/>.

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

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

to consider design and administration aspects of a potential CGT in New Zealand; hence the purpose of this paper.

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

The next section provides an overview of the UK's experience with a CGT.

3. CAPITAL GAINS TAX IN THE UNITED KINGDOM

3.1 Overview

Capital gains tax was introduced in the UK in 1965 giving half a century of experience which may be relevant to discussion of a possible CGT in New Zealand. There are several interesting strands to the UK experience. First of all there are strong theoretical reasons for the introduction of a capital gains tax on the grounds of economic efficiency and fairness and both were used to support the case for the tax in the UK. Nevertheless, a second relevant observation is that the UK CGT has never been of the pure form indicated by basic principles of good tax design. Sometimes it has moved closer to the theoretical ideal and sometimes further away so indicating the importance of other factors in the development of the tax. Indeed a third point is that such changes suggest CGT is a fairly robust tax unlike, for example, the ill-fated capital transfer tax[39]. A final strand of interest in the present context is that, however close its relation to basic principles has or has not been, the UK CGT has not aroused much general opposition and what there has been is insignificant compared to the negative reaction to some other tax changes such as the introduction of the community charge[40]. Sir Thomas White once suggested that the

[39] See, eg, Alister Sutherland, 'Capital transfer tax: an obituary' (1981) 2(3) *Fiscal Studies* 37-51 and Alister Sutherland, 'Capital transfer tax: adieu' *Fiscal Studies* (1984) 5(3) 68-83.

[40] See, eg, Simon James, 'The contribution of behavioral economics to tax reform in the United Kingdom' (2012) 41(4) *Journal of Socio-Economics* 468-475.

only popular tax is one on someone else[41] and it is true that the lack of opposition to the UK CGT is partly due to it the being levied on a relatively small proportion of taxpayers but even they have not generally voiced much criticism of the tax. Where significant criticism has been raised about particular aspects of the tax it has led to reform as for instance in 2008 with the introduction of entrepreneurs' relief. It seems reasonable to conclude that the CGT in the UK has managed to achieve an acceptable balance between policy, principles and administration.

Several basic principles are relevant to developing a good tax system but the most important with respect to CGT are economic efficiency and equity together with administrative considerations.[42] Economic efficiency holds that taxes should not unnecessarily distort markets that are working well though, if there are market imperfections, there may be a case for corrective taxation. An equitable tax is one that is seen by taxpayers as fair and is consistent with distribution policy more generally. Administrative considerations include the avoidance of excessive complexity and administrative and compliance costs.

In terms of the economic principles of taxation, capital gains can have similar characteristics as income. For instance, the capital appreciation of securities as a result of ploughing back profits may be seen as another form of income. In economic terms, the precise definition of income has been the subject of considerable debate among eminent economists. For Haig 'income is the money value of the net accretion to economic power between two points of time'[43]. Henry Simons' comprehensive definition of income was that : 'Personal income may be defined as the algebraic sum of (a) the market value of rights exercised in consumption and (b) the change in the value of the store of property rights between the beginning and end of the period in question'[44]. Hicks' definition took income as the 'maximum amount of money which the individual can spend this week, and still be able to spend the same amount in real terms in each ensuing week'[45]. The

[41] Sir Thomas White, 'In such experience as I have had with taxation – and it has been considerable – there is only one tax that is popular, and that is the tax on the other fellow' (debate in the Canadian Parliament, 1917).
[42] Simon James and Christopher Nobes, *The Economics of Taxation: Principles, Policy and Practice* (Fiscal Publications, 15th ed, 2015).
[43] Robert M Haig, 'The concept of income' in Robert M Haig (ed), *The Federal Income Tax* (Columbia University Press, 1921).
[44] Henry C Simons, *Personal Income Taxation* (University of Chicago Press, 1938).
[45] John R Hicks, *Value and Capital* (Oxford University Press, 2nd ed, 1974).

definition that seems to be increasingly accepted is that of total accretion, that is the accrual of wealth. This includes as income an individual's spending in a given period, plus any changes in net wealth. With such a definition a range other gains including inheritances, gifts, winnings from gambling and any 'windfall' gains might be considered as income for tax purposes.

Considered in this way, if only some forms of income are subject to tax, the result may well be significant economic distortions as taxpayers manipulate their affairs for tax purposes only. An important aspect is that, in the absence of a capital gains tax, there may be a significant tax incentive to invest in 'non-productive' assets such as antiques, coins, paintings, precious stones and stamps and so on which are bought because of anticipated increases in their value, rather than for any productive purpose. On equity grounds, if capital gains are equivalent to income they should be subject to tax in the same way. The fairness argument is also a strong one because, of course, capital gains accrue very unevenly across the population. The importance of equity in the introduction of the CGT in the UK is evident from the following statement by The Chancellor of the Exchequer (Mr. James Callaghan) in 1965:[46]

> First, I begin with tax reform. The failure to tax capital gains is widely regarded, outside as well as inside the Labour Party, as the greatest blot on our existing system of direct taxation. There is little dispute nowadays that capital gains confer much the same kind of benefit on the recipient as taxed earnings more hardly won. Yet earnings pay tax in full while capital gains go free. This is unfair to the wage and salary earner. It has in the past been one of the barriers to the progress of an effective incomes policy, but now my right hon. Friend the First Secretary of State has carried this policy forward to a point which many did not believe was possible six months ago. This new tax will provide a background of equity and fair play for his work.
>
> Moreover, there is no doubt that the present immunity from tax of capital gains has given a powerful incentive to the skilful manipulator of which he has taken full advantage to avoid tax by various devices which turn what is really taxable income into tax-free capital gains. We shall only make headway against avoidance of this sort when capital gains are also taxed.

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

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

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

Valuation is another major consideration. Even with the realisation basis, valuation is required both when an asset is bought, and when it is sold. For some types of assets, such as shares quoted on the Stock Exchange, valuation is relatively simple. For other types of assets, such as unquoted shares, it can be very much harder.

3.2 The United Kingdom Experience

Although there had been previous attempts to tax certain types of capital gains, especially from land, the systematic taxation of gains did not begin until 1962. In that year a tax on short-term gains was introduced. In 1965 a more comprehensive capital gains tax came into operation. The tax is levied on a wide range of assets, but there are several exemptions, including a taxpayer's only or main residence, motor vehicles and gambling winnings. The justification for exempting the last of these was that, as there is no capital asset, there cannot be a capital gain. There is also an individual annual allowance of £11,100 (in 2015/16 - approximately $26,500 NZ dollars).

In its early years, capital gains tax was subject to a separate rate of tax, which was 30 per cent from 1965 to 1988. However, the argument that capital gains are a form of income and should be taxed accordingly eventually prevailed. In his 1988 Budget speech the Chancellor of the Exchequer stated:

> In principle, there is little economic difference between income and capital gains, and many people effectively have the option of choosing to a significant extent which to receive. And in so far as there is a difference, it is by no means clear why one should be taxed more heavily than the other. Taxing them at different rates distorts investment decisions and inevitably creates a major tax avoidance industry. Moreover, at present, with capital gains taxed at 30 per cent for everybody, higher rate taxpayers face a lower – sometimes much lower – rate of tax on gains than on investment income, while basic rate taxpayers face a higher rate of tax on gains than on income. This contrast is hard to justify.[47]

From 1988/89 onwards the rates of capital gains tax were brought into line with those of income tax so that capital gains tax was charged at the taxpayer's highest income tax rate. Nevertheless capital gains were still treated more favourably than other forms of income. As Robinson pointed out, even after the 1988 reform, capital gains tax was payable in arrears, deferred on gifts, gave relief on retirement and exemptions on death.[48] After years of criticism of the inequitable effects of inflation on capital gains the government brought in a system of indexation based on the Retail Prices Index. This 'indexation allowance' gave relief for inflation between 1982 and 1998. From 1998 taper relief was introduced which reduced the amount of the gain according to the length of time the asset had been owned.

However in 2008 both taper relief and indexation allowance were withdrawn and the rate of capital gains tax was changed from a person's top rate of income tax to a flat rate of 18 per cent. There were both winners and losers as a result of this change and after strong lobbying an entrepreneurs' relief was also introduced in 2008. This applied where, subject to certain restrictions, all or part of a business is sold and can reduce the effective rate of tax on some gains to 10 per cent. In 2010 a new rate of 28 per cent was introduced for capital gains of individuals with total taxable gains and income which put them in the higher rate income tax band (currently 40 per cent). Capital gains accruing to

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[47] Hansard, 15 March 1988, col. 1005.

[48] Bill Robinson, 'Reforming the taxation of capital gains, gifts and inheritances' (1989) 10(1) *Fiscal Studies* 32-40.

incorporated companies are also taxed but by corporation tax on their gains rather than capital gains tax.

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

4. LESSONS FROM THE UNITED KINGDOM

4.1 Labour's Capital Gains Tax Policy – An Introduction

Not unexpectedly the purpose of Labour's CGT proposal is couched in somewhat political and populist rhetoric. For example, comments in the 2011 policy statement such as "[t]his tax switch is about creating a fairer tax system" echo Adam Smith's equity canon for a good income tax[49] and resonate with commentators,[50] and groups such as the OECD[51] who have long highlighted the inequity present in the NZ tax system absent a comprehensive CGT. As noted from the UK Chancellor of the Exchequer's speech (referred to in Section 3.1 of this paper), equity concerns were pivotal to the introduction of a CGT in the UK.[52]

The 11-page 2014 policy statement contains detailed discussion of aspects of the design features of the proposed CGT. The realisation-based CGT will apply to a wide range of assets and be levied at a single rate of 15% and with no tax-free threshold. Personal

[49] Labour Party, above n 32, 4.

[50] See, eg, Chris Evans and Cedric Sandford, 'Capital Gains Tax – The Unprincipled Tax?' [1999] 5 *British Tax Review* 387, 403.

[51] 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 framework and stated that a CGT could, along with other tax changes, "facilitate a more efficient and equitable tax structure": OECD, *OECD Economic Surveys: New Zealand* (OECD Publishing, 2013) 24.

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

assets, collectables, small business assets sold for retirement and payouts from retirement savings schemes will be exempt from the CGT. The CGT will apply to gains accrued after implementation, i.e. from a specific valuation date. Capital gains on inheritance passed on after death will be rolled over to the heir and CGT will be payable when the asset is realised. Capital losses will be carried forward and offset against future capital gains. Individuals who are classified as dealers will continue to be subject to tax on such gains at their marginal tax rates. An Expert Panel would be established to deal with technical issues. The 2014 policy statement estimates the CGT would raise an additional $1.035 billion in tax revenue by 2020/21.[53]

The design of a comprehensive CGT for New Zealand could essentially proceed along two lines (or a combination of the two). First, the CGT could be developed on the basis of the strict adherence to a 'pure form' of the tax as indicated by the basic principles of good tax design, levied on an accrual or unrealised basis with few, if any exemptions.[54] This form of CGT has been rejected by various NZ committees – let alone other countries - as unworkable. Second, (and the approach favoured by the authors) is that it could be based on a pragmatic approach which considers broader tax administration and policy design principles. Compromise and trade-off will be required under such an approach. Such an approach is contrary to that adopted by the GST where the policy design strongly focussed on simplicity but will be necessary for the successful implementation of a CGT.[55]

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

[53] TWG, above n 52, 2.

[54] See, eg, Leonard Burman and David White, 'Taxing Capital Gains in New Zealand' (2003) 9 *New Zealand Journal of Taxation Law and Policy* 355. Therefore, "From a design perspective, there should be no exemptions as having exemptions means opportunities for manipulation of the regime.": Shaleshni Sharma and Howard Davey, 'Characteristics of a Preferred Capital Gains Tax Regime in New Zealand' (2015) 21 *New Zealand Journal of Taxation Law and Policy* 113, 125.

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

administrative impacts). Indeed, the 2014 policy statement acknowledges that indexation has been abandoned in the CGT regimes the United Kingdom and Australia due to its practical difficulties.[56] The following Table summarises key characteristics of the UK CGT with the Labour Party policy.

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

	UK	**NZ**
Introduced (general)	1965	Proposed
Implementation	From 6 April 1965	From specific date ("valuation day").
Tax Base	Capital gains realised on disposal of capital assets.	Capital gains realised on disposal of capital assets.
Separate Tax or part of the income tax code delete this one as not significant?	Separate – under the Taxation of Chargeable Gains Act 1992.	No information.
Distinction between long term and short term gains (including tapering relief)	No –taper relief ceased from 5 April 2008.	No information

[56] Labour Party, above n 33, at 5. Evans and Sandford also argue against indexation on the basis it does not exist for capital or income and there is no need in a low inflation environment: Evans and Sandford, above n 52, 404.

	UK	NZ
Tax Rates	There is a flat rate of 18% for basic rate income taxpayers on capital gains net of any losses. For additional and higher rate income taxpayers the rate is 28%.Trustees pay 28% on capital gains and 10% for sole traders or partnerships if the gains qualify for Entrepreneurs' Relief. Companies pay corporation tax on gains not CGT.	Flat rate of 15% for individuals. Expert Panel to consider CGT application to other entities including companies and trusts.
Indexation of cost base	No indexation relief since 6 April 2008.	No
Tax free threshold (for capital gains)	Annual at £11,100 (for 2015-2016). Trusts £5,550.	No
Indexation of tax-free threshold	(not quite right – not formally indexed but it does go up every year – perhaps delete this?)	N/A
Capital losses 'ring-fenced'?	Yes – offset against current and future gains indefinitely. Can be carried backwards for gains at death	Yes - offset against current and future CGT liability. Expert Panel to consider upper limit for offset of losses.
Treatment of gains at death	No CGT but rollover provisions for heirs and taxable at market value on realisation.	No CGT but rollover provisions for heirs and taxable at market value on realisation

	UK	NZ
Treatment of gifts	Gifts subject to CGT unless to spouse, partner, civil partner or charity.	Gifts subject to CGT. Rollover where assets transferred between a couple in relationship break-up.
Private residence exempt?	Yes	Yes
Personal property exempt?	Yes - CGT on disposal of personal possession for £6,000 or more (eg jewellery, paintings, antiques, coins and stamps, sets of things such as matching vases or chessmen). No CGT on motor vehicles unless used for business and anything with a limited lifespan, eg clocks - unless used for business.	Yes - personal property (eg boats, furniture, electrical goods, household items) and "collectables"(eg jewellery, antiques, artwork, stamp collections).
Treatment of savings schemes	No CGT on shares or units held in NISAs (New ISAs), ISAs (Individual savings accounts) or pensions.	Expert Panel to consider taxation of KiwiSaver and Portfolio Entity (PIE) funds. Pay-outs from retirement savings schemes, such as KiwiSaver exempt.
Other exemptions	UK government gilts and Premium Bonds, compensation for damages for personal or professional injury, betting, lottery or pools winnings.	Lump sum compensation (eg redundancy, ACC or court awards), life insurance policy surrendered or sold, winnings or losses from gambling, medals.

	UK	**NZ**
Business relief	Yes – provided under the Entrepreneurs' Relief which allows for a lower rate of CGT (10%) to be paid by people who have been with and employed by a trading company for more than a year and have at least a 5% shareholding. Claims may be made on more than one occasion up to a "lifetime" total of £10 million. Business Asset Rollover Relief – allows deferral of CGT if carrying on business and new business assets acquired within 3 years of disposal of old assets. Gift Hold-Over relief – no CGT where business assets are given away or sold for less than they are worth.	Yes – gains up to a maximum of NZ$250,000 for small business assets sold for retirement, where the owner is over a certain age (eg 55) and has owned the business for 15 years and has been working in the business. Other rollovers not detailed – rollover where taxpayer disposes of one asset and replaces with a similar asset suggested in Labour policy statement.
CGT apply to non-residents?	Only on gains on sale of UK residential property made after 5 April 2015 (unless private residence exemption applies)	Yes – Expert Panel to consider details.
Persons migrating from the subject country	No deemed disposal on leaving the UK. No CGT charge unless legislation deems the departure to be an event giving rise to a deemed disposal.	Subject to CGT with the exception of land, buildings and business assets.

The remainder of this section compares and critiques key aspects of the design of Labour's CGT included in the Table with the UK experience, using a very 'pragmatic' approach. Following the lead of Labour's policy statements, this paper focusses on the application of the CGT to individuals and not entities.

4.2 The Incidence of the Tax

Echoing Sir Thomas White's observation in Section 1.0 of this paper, Sharma and Davey in their NZ survey similarly observe: "One of the major challenges identified by 50 percent of the participants is the negative public perception of CGT. Participants argued that people do not like to pay tax and CGT is another form of taxation."[57] The 2014 policy statement estimates, based on Australia's experience, that the CGT would impact in any one year on less than 10 per cent of taxpayers (or about 267,000 people).[58] At the outset of any future debate on a CGT in NZ, policy makers need to articulate the limited impact of the CCT, assuming the tax contains the typical exemption for the main residence and personal property (see Sections 4.4 and 4.6 respectively). The inclusion of a tax-free threshold, as adopted in the UK (see Section 4.3), will also reduce the number of taxpayers subject to the tax and increase support for the CGT. These measures would also improve the economic efficiency of the tax and have administrative benefits, reducing compliance and administrative costs.

4.3 Introducing Progressivity

As noted in Section 2.2, Labour proposes imposing a CGT at the flat rate of 15 per cent on the net gain made by individuals. 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[59] and "makes some allowance for the effect of inflation".[60] It also reflects that there

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[57] Sharma and Davey, above n 54, 132.
[58] Labour Party, above n 33, 2.
[59] The NZ income tax rates for individuals are:

Income bracket	*Tax rate*
\$0 - \$14,000	10.5 per cent
\$14,001 - \$48,000	17.5 per cent
\$48,001 - \$70,000	30.0 per cent
\$70,001 and over	33.0 per cent

is "often some risk associated with investment for capital gains as opposed to other investments."[61] The low CGT rate will reduce the risk of taxpayers holding onto assets, i.e. "lock-in" effects referred to above.[62]

The UK, by way of contrast, with the adoption in 2010 of the 28% CGT rate now taxes capital gains at one of three CGT rates.[63] Capital gains up to £11,100 are exempt from CGT. Individuals deriving gains above that threshold are subject to CGT at the flat rate of 18 percent, or 28 percent for individuals earning more than the income tax band of £31,785 (from the 2015-2016 tax year).[64] This three rate structure introduces progression into the CGT system, particularly incorporating elements of vertical equity. It is interesting to note that the UK has twice moved away from a flat CGT rate, in 1988 and 2010.

In the New Zealand context while the flat CGT rate proposed by Labour is lower than the tax rates on ordinary income, a situation which would not normally be viewed as increasing progressivity and meeting the vertical equity criterion, since New Zealand presently does not tax capital gains, this is a move toward vertical equity.[65] However, equity concerns remain. While there is clear rationale for the 15 per cent CGT rate, the low rate "negates many of the benefits of introducing the tax".[66] The reality is that as it is lower than three of the present four tax brackets for individual taxpayers – in fact, half or less than the top two rates - an arbitrage opportunity will exist between income from

[60] Labour Party, above n 33, 5.
[61] Ibid.
[62] Labour Party, above n 33, 5.
[63] In fact, if the Entrepreneurs Relief, with a tax rate of 10% (see Section 4.7 of this paper), is included, there are in fact four CGT rates.
[64] The UK income tax rates for individuals for 2015/16 are:

Income bracket	*Tax rate*
£0 - £31,785	20 per cent
£31,786 - £150,000	40 per cent
Over £150,000	45 per cent

In addition, there is a personal allowance of £10,600.
[65] This impact on progressivity is acknowledged by the New Zealand Treasury in July 2013 who observed that a CGT could have (positive) implications for both horizontal and vertical equity; with respect to the latter probably making the tax system more progressive: The Treasury, *Affording Our Future – Statement on New Zealand's Long-Term Fiscal Position* (Wellington, July 2013) 27 <www.treasury.govt.nz/government/longterm/fiscalposition/2013/affordingourfuture/ltfs-13-aof.pdf>.
[66] Julie Cassidy and Clinton Alley, above n 18, 120.

capital and income from labour. This will lead to horizontal inequity and impact on the administration of the tax. The difficulties that exist in differentiating between income and capital in the current NZ tax system absent a CGT "will continue to be perpetuated despite the introduction of a CGT"[67] under Labour's proposal. In addition, on the basis that capital gains tend to be derived by higher wealth individuals, the effective concessional tax rate for capital gains will benefit that group more.

In terms of tax design, these equity concerns could be ameliorated through the adoption of a more progressive CGT scale as utilised in the UK. This could be achieved by the adoption of two measures, first the addition of at least one additional tax rate for capital gains above a certain level (or alternatively, treat capital gains as ordinary income subject to the existing individual income tax rates), and second, the introduction of a tax-free threshold. This second suggestion has support from interviewees in Sharma and Davey's NZ study who recommended that there should be a general tax-free threshold of $10,000 and a tax-free threshold of $50,000 for personal items.[68]

While the tax- free threshold would further reduce the tax base and consequently revenue by excluding small capital gains, the perception of greater progressivity introduced by this measure would be significant. The introduction of an additional, higher tax rate on capital gains typically made by higher income earners would offset some of this revenue loss. In addition, to ensure the effectiveness of the tax-free threshold remains, as occurs in the UK, the tax free threshold should be indexed.

From a tax administration perspective there are two very practical benefits to the introduction of a tax-free threshold in NZ.[69] First, it "has the advantage of significantly reducing the operating …. costs related to the CGT, by eliminating the 'minnows and tiddlers' from the CGT net, without impugning the overall integrity of the regime."[70] Second, individuals, who are classified as a "non-filing taxpayer" are currently not required to file a tax return. Typically such a person has all their annual gross income taxed at source and any interest or dividends will have resident withholding tax (RWT) deducted. The implementation of Labour's CGT (or an equivalent) would see this group required to file a tax return upon making a capital gain with the consequent costs this

[67] Ibid.
[68] Sharma and Davey, above n 54,129.
[69] Section 33A(1) of the Tax Administration Act 1994.
[70] Evans and Sandford, above n 50, 404.

would entail. A tax free threshold would ensure this group – to the extent they only make small capital gains – will retain their non-filing status. This has the advantage of reducing both compliance and administrative costs.

4.4 Tax Appeasement - the Main Residence Exemption

In line with the UK (and other CGT regimes), Labour's 2014 policy statement exempts the main residence. This reflects overseas experiences that suggest "an exemption for the primary residence is needed in order to garner support and make the introduction of a CGT politically palatable."[71] Holiday homes will be included as part of the CGT regime (except where passed down from one generation to another) as to exempt them would lead to loopholes, as well as definitional and administrative issues.[72] 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.[73] Similarly, in respect of farms, the primary farm residence and surrounding land used for domestic purposes (the curtilage) will be exempt from CGT.[74] The wider land used in the farming business will be subject to the CGT.

The exemption of the primary residence is contrary to a "pure" CGT and reduces the revenue to be raised from the tax.[75] 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 base".[76] Whether this issue is addressed requires a consideration of, and trade-off, between principles of good tax design and tax administration. Focussing on tax principles a better approach to address the equity and economic efficiency with an unlimited exemption would be either to have no exemption

[71] Jacob Spoonley, 'A Sanctuary from the Taxman?: The Design of the Primary residence Exemption' (2015) 21 *New Zealand Journal of Taxation of Law and Policy* 69.
[72] Labour Party, above n 33, 7.
[73] Ibid 8.
[74] Ibid 7.
[75] 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* (New Zealand), 10 December 2012. Shewan has estimated that the revenue from a CGT in NZ would drop from $8.89 billion annually to $4.54 billion annually if owner-occupied housing was excluded: Shewan, at slide 6, as cited in Spoonley, above n 71, 86.
[76] 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 18, 296. Abelson and Joyeux are reported as "estimating the static loss to the tax base to be between A$7.2 and A$10 billion per year, depending on assumptions about gains growth.": at 296.

for the main residence – a politically unpalatable approach – or 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 as has been adopted in the US[77] and more recently South Africa.[78] Spoonley notes that a limited exemption "provides a significant opportunity to contribute greater vertical equity and progressivity."[79] Against this, is the need to address administrative considerations. A capital gains tax is complex. A minimum exempt threshold would add a further layer of complexity and consequent additional costs - both of a compliance and administrative nature. On this basis, and to ensure electorate support, despite the impact on equity and economic efficiency, an uncapped exemption for the main residence is preferable.

4.5 Attracting Tax Investment or Tax Preference - Residential Property and Non-Residents

Labour's 2014 policy statement provides that in principle, non-residents will subject to the CGT in the same way as New Zealand resident taxpayers.[80] Elliffe[81] observes that "many other countries do not tax non-residents on the sale of personal property and, in particular, shares in companies resident in their country, where the income could be said to have a source in their jurisdiction."[82] The issue from a tax policy perspective with a non-comprehensive CGT regime is that it could give foreigners a tax advantage that

[77] In the United States, a person's main personal resident is not excluded from capital gain treatment, but there is a USD 500,000 exemption (for married filing jointly and USD 250,000 for single taxpayers), subject to certain conditions including living in the home for a specified period: Spoonley, above n 71, 76. This capped threshold was introduced, at this level in 1997 and has not increased. When enacted it was generous, being "set well above the median house price at the time.": at 76.

[78] South Africa's regime exempts gains on primary residences up to ZAR 1.5 million: Huang and Elliffe, above n 18, 296. At the time of writing, ZAR 1.5 million is equivalent to NZD 164,636 (7 February 2014). Alternatively, CGT could be deferred through roo-over: Evans and Sandford, above n 50, 404. In reality, Spoonley concludes that from a tax design perspective horizontal equity improvements from a capped exemption are "only small": Spoonley, above n 71, 74. Spoonley also cites Jane G Granville and Pamela J Jackson, 'The Exclusion of Capital Gains for Owner-Occupied Housing' (RL32978, Congressional Research Service, 26 December 2007) 7 also acknowledge that in the US the capped exemption "has not reconciled inequities between homeowners with different job circumstances, between those who live in different parts of the country, and between those with different health needs." They do note, with the exception of regional-based inequities, allowances for certain taxpayers can address inequities related to job and health circumstances: at 7.

[79] Spoonley, above n 71, 74. In support, he cites for example Richard Krever and Neil Brooks, *A Capital Gains Tax for New Zealand* (Victoria University Press for the Institute of Policy Studies, 1990) 93.

[80] Labour Party, above n 33, 11.

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

[82] Ibid 93.

cannot be enjoyed by NZ residents.[83] However, the argued benefit for countries such as Australia, which have narrowed the range of assets for which a non-resident may be subject to CGT, is to enhance the status of that country as an attractive place for investment and business.[84] This is a difficult policy issue.

The CGT in the UK does not generally apply to non-residents. However, recent changes in this respect in the UK may be instructive from a design perspective. As a result of legislative amendments, UK residential property disposals by UK non-resident individuals may be subject to CGT on any gains made on disposals made after 5 April 2015. A non-resident will pay CGT on the gain from the sale of a UK residential property that is not their main home, or their main home if it is let it out, if they have used it for business, had long periods of absence or it is very large. The HM Treasury Autumn Statement 2013[85] announcing this extension of the CGT stated that inter alia the change was to "ensure that those with the most in society make a *fair contribution*".[86] In addition, the change has an administrative focus as it "is intended to harmonise the UK system with other jurisdictions that charge tax on the basis of where the property is located rather than where the owner is resident." It was also reported that the measure was aimed at curbing soaring house prices.[87] This change to the taxation of real property owned by non-residents will mean that the position in the UK will be broadly similar to the US, South Africa and Canada.[88]

As noted earlier in this paper, NZ house prices (particularly in Auckland)[89] have grown strongly in recent years. Among the reasons cited include the impact of speculators and foreign investors in the market.[90] From a tax policy perspective, measures such as those

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[83] Ibid.
[84] Ibid 94.
[85] HM Treasury, *Autumn Statement 2013* (HM Treasury, United Kingdom, December 2013) <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263942/35062_Autumn_Statement_2013.pdf>.
[86] Ibid 9. Emphasis added
[87] 'Britain to tax foreign property investors from 2015 – Osborne', *Reuters.com* (online), 5 December 2013.
[88] Elliffe, above n 81, 94.
[89] Suze Metherell, 'House prices rise at fastest pace in nine years', *NBR* (online), 3 November 2015 <http://www.nbr.co.nz/article/house-prices-rise-fastest-pace-9-years-b-181041?utm_source=newsletter&utm_medium=email&utm_campaign=NBR%2520Property%2520-%25207-Day%2520Wrap>.
[90] 'Tighter Rules on Residential Property Investors and Overseas Buyers', *NBR* (online), 17 May 2015 <http://www.stuff.co.nz/business/68612603/tighter-rules-on-residential-property-investors-and-overseas-buyers>.

introduced into the UK with respect to non-resident property owners would sit well in the New Zealand context in terms of the political viability of the CGT given housing affordability issues. However, the benefit of this measure, at least in the NZ context, may primarily be symbolic as it is unclear what impact foreign speculators have had on house prices compared with, for example, lack of supply and increasing immigration into New Zealand.

4.6 Compliance and Administrative Cost Minimisation - Personal Use Property

The Labour party proposal would entirely exempt items such as boats, furniture, electrical goods and household items (termed "personal property")[91] along with "luxury" items such as "the millionaire's super yacht".[92] The policy rationale for this exemption is that such assets (especially luxury items) tend to depreciate over time and to levy the CGT on such items would provide a tax incentive due to the ability to write off capital losses (against capital gains).[93]

"Collectables" such as jewellery, antiques, artwork, rare folios or stamp collections will also be exempt unless the person is a trader.[94] Taxpayers who regularly trade in these items (and personal property)[95] will continue to be assessed on their profits as ordinary income under existing sections in the Income Tax Act 2007.[96]

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

However, the exemption also needs to be considered in the light of good policy design as the likely behavioural response of taxpayers will be to invest in these types of assets. Collectables, such as artworks and antiques, tend to be owned by higher wealth

[91] Labour Party, above n 33, 6.
[92] Ibid 4.
[93] Ibid.
[94] Ibid 4, 6.
[95] Ibid. Transactions in respect of land are covered by a separate suite of sections in the Income Tax Act 2007, ss CB 6A – CB 23.
[96] See, eg, s CB 5 of the *Income Tax Act 2007* (NZ).

individuals and appreciate in value. Labour's policy, in this respect, is therefore contrary to its overall objectives for implementing the tax - "creating a fairer tax system"[97] - as essentially it provides a tax break for (generally higher wealth) owners of these assets. The broader question that also needs to be answered is whether investment in such collectables is to be encouraged. As a tax policy consideration, arguably these are generally not the types of assets that a nation wants to incentivise investing in; instead, tax policy should focus investment into productive sectors of the economy, encourage investment and innovation as well as the creation of jobs. One of the key reasons a CGT is promoted by Labour (along with some commentators) is that it "will help shift the focus of investment from speculation on property to the productive export sector."[98] The exemption of collectables is clearly contrary to that policy and will not improve economic efficiency but lead to further investment in non-productive assets.

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

Any future CGT in New Zealand, from a tax policy perspective, if it is to encourage greater equity and economic efficiency in the tax system, should apply to collectables. As mentioned this would make the CGT more progressive as these assets tend to be owned by wealthy individuals. From a tax administration perspective, smaller gains could be excluded either by a targeted threshold as in the UK or to the extent any gains come within the general tax-free threshold (assuming one exists, as discussed in Section 4.3 of

[97] Labour Party, above n 32, 4.
[98] Labour Party, above n 33, 15.

this paper). However, this overall approach will also have negative implications for tax administration. Taxpayers buying and selling collectables will be incentivised to adopt the position that they are not dealing and are therefore are subject to the CGT (including any exempt threshold) and not income tax. While a similar incentive presently exists and there is case law which considers the characteristics of a dealer, the boundary (of what a dealer is) will come under greater pressure with the consequent effect on the administration of the tax by Inland Revenue.[99] The same incentive arises in respect of gains from the sale of personal property outside the collectable (and personal use) category except where a loss arises, in which case a taxpayer would want to adopt the converse position (and offset the loss against ordinary income). The incentive to undertake such positions will negatively impact on the administration of the tax.

4.7 "Remember the little fella" - Business Concessions

The 2014 policy statement proposes the exemption of "[s]mall business assets, up to a maximum of $250,000, sold for retirement, where the owner is above a certain age (e.g. 55) has held the business for 15 years and has been working in the business".[100] 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.[101] The concession will also apply to the sale of farming businesses.

From a tax administration perspective any such exemption has the potential to create additional complexity, irrespective of how the term "small business" (or equivalent) is defined and will lead to taxpayers attempting to structure into the provision. A specific anti-avoidance provision will be required to prevent this. This will impact on tax compliance and administrative costs. 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, from a policy perspective the exemption proposed by Labour is laudable and recognises the reality that NZ is a nation of small businesses.[102] It is estimated that there

[99] Andrew Maples, 'A Comprehensive Capital Gains Tax in New Zealand – No Longer Political Hari-Kari? A Consideration of the Labour Party Proposal of 2011' (2014) 20 *New Zealand Journal of Taxation Law and Policy* 144, 161.
[100] Labour Party, above n 33, 6.
[101] Ibid 7.
[102] Interestingly, 67.5 percent of those interviewed by Sharma and Davey did not advocate exemptions for small or new businesses in NZ on the basis such an exemption could be manipulated: Sharma and Davey,

are 460,000 small-to-medium enterprises (SMEs) in New Zealand.[103] SMEs make up about 97 per cent of businesses in New Zealand, and almost 70 per cent of them are single-worker businesses. For many of these enterprises all their resources are invested in the business and thus it is a de facto retirement savings vehicle for the business person. In addition, it is unlikely that they will have made separate provision for retirement via a savings scheme. Accordingly, as good tax policy the CGT should not penalise investment generally and, specifically those making provision for their retirement through running a SME should not be disadvantaged. In addition, SMEs already face high (regressive) tax compliance costs. Perhaps reflecting this existing tax compliance burden, support for a CGT among businesses was far from universal with one poll suggesting that "60 percent of small and medium-sized business owners are negative about the Labour Party's [2014] capital gains tax".[104] Moves to address administration issues for this group will be important for the success of any CGT proposal.

Labour's small business exemption raises two issues. First, given the policy objectives, should the exempt amount be higher, and second, does the exemption need to be extended, eg should other forms of (small) business relief be considered to encourage investment and innovation.

The UK experience in this regard is instructive. As a general observation, the relief available is not limited to retirement. First, the Entrepreneurs' Relief allows for a lower rate of CGT (10%) to be paid on gains arising from the sale of certain business assets by individuals who have been with and employed by a trading company for more than a year and have at least a 5% shareholding. Claims may be made on more than one occasion up to a "lifetime" total of £10 million.[105] In addition, Business Asset Rollover Relief allows for the deferral of CGT on sale of a business asset if a person is carrying on a business and new business assets are acquired within 3 years of the disposal of the original assets.

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above n 54, 129. In addition, the interviewees "argued that the size of the business is irrelevant to the imposition of and liability to pay CGT; otherwise, the effects of CGT are watered down which defeats the purpose of having CGT in the first place.": at 129.

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

[104] 'Small business owners negative on capital gains tax – survey', *The New Zealand Herald* (online), 5 September 2014), <www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11319576>.

[105] HN Revenue and Customs, *Guidance: HS275 Entrepreneurs' Relief* (2015) <https://www.gov.uk/government/publications/entrepreneurs-relief-hs275-self-assessment-helpsheet/hs275-entrepreneurs-relief-2015>.

Finally, in the UK, under the Gift Hold-Over relief, no CGT arises where business assets are given away or sold for less than they are worth.

Evans and Sandford argue on equitable grounds that rollover "provisions need to exist where involuntary disposals occur (compulsory acquisitions, corporate takeovers and mergers, destruction of assets through natural disasters, etc)."[106] 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."[107] 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.[108] 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[109] and necessitate the introduction of anti-avoidance measures which add to complexity of the provisions.[110]

5. CONCLUSION

Tax Administration covers a range of aspects of taxation including the development and formulation of tax policy relating to tax legislation.[111] As noted at the commencement of this paper, in developing tax design, tax principles are a valuable guide. However, the optimal outcome may require modification in the light of tax policy and the reality of tax administration.

The overarching policy underpinning the design of the New Zealand tax system is that it should have a broad-base, low rate tax structure. In practice this means a focus on the principles of simplicity and convenience - New Zealand's very successful GST is a good example of this policy. In an ideal world the design of a CGT should complement the BBLR approach. However, the long-standing antipathy against a CGT means that policymakers will need to address key electorate concerns for a CGT to be accepted in NZ. As posited in Section 2.0 of this paper, the lack of consideration of tax administration

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[106] Evans and Sandford, above n 50, 404.
[107] Ibid.
[108] Tax Review 2001, *Final Report* (Wellington, 12 October 2001) 34.
[109] New Zealand Planning Council, *For Richer or Poorer: Income and Wealth in New Zealand – The First Report of the Income Distribution Group* (Wellington, June 1988) 80.
[110] Cassidy and Alley, above n 18, 99.
[111] US Legal, definition available at: <http://definitions.uslegal.com/t/tax-administration/>.

aspects of a possible CGT in the various reports and Labour's policy statements may go some way to explain the hostility to the tax. Therefore in designing a future CGT policymakers will need to balance good tax design principles with tax administration considerations. This will be a challenge. At a practical level a departure from the BBLR and its consequential focus on simplicity will therefore be required. It is clear from a consideration of the UK CGT regime that it introduces significant additional complexity into the tax system, due in part to policymakers introducing specific concessions. While in a 'pure' system such exemptions and concessions should be limited to minimise complexity and opportunities for tax planning, from an administration perspective there are a strong arguments for some relief, such as a tax free threshold, to reduce compliance and administrative costs.

The success of a CGT, or any tax, will therefore inter alia depend on a clear policy rationale which informs the design, consultation and implementation phases. "Should New Zealand introduce a CGT merely to introduce a CGT, the CGT is likely to miss the mark and will be subject to constant remedial changes. During the design process, New Zealand needs to define the problem(s). The CGT then needs to be designed with the specific problem(s) in mind."[112] However, the design process should not simply focus on good tax principles but also tax administration considerations.

Ministers of Parliament 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 design and administration considerations should ensure that lobby group pressure does not derail the tax. 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 and tax administration considerations 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."[113]

The near future would be an ideal opportunity to implement a CGT in NZ as the Inland Revenue has embarked on the Business Transformation programme. This a multi-year,

[112] Brad Bowman, 'Capital Gains Tax: Setting a good foundation (before the inevitable squabble)' (2014) 78 *Taxation Today* 13, 14.

[113] Malcolm Gammie, 'Taxing Capital Gains – thoughts from the UK' (2000) 23 *University of New South Wales Law Journal* 309.

multi-stage change programme seeks to “modernise New Zealand's tax service to make it simpler and faster for New Zealanders to pay their taxes and give more certainty that they'll receive their entitlements.”[114] The 10-year programme[115] involves changes that “will simplify and streamline [Inland Revenue’s] business processes, policies and customer services as well as upgrade [Inland Revenue’s] technology platform.”[116] Any future CGT design should benefit from the fruits of the Business Transformation programme with its focus on tax administration considerations.

The introduction of the goods and services tax in NZ in 1986 “suggests that a politically controversial new tax can be implemented in New Zealand, with exemptions that depart from the theoretical ideal, but not disintegrate over time.”[117] 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 UK. In the event that NZ does ultimately progress down the path of implementing a CGT it is therefore hoped that NZ maximises this opportunity to draw on the experience of the UK, not simply from a tax policy and design perspective, but also with a focus on tax administration considerations.

[114] Inland Revenue, *Business transformation: About Business transformation* (25 February 2015) <http://www.ird.govt.nz/transformation/about-business-transformation/about-business-transformation-index.html>.
[115] Paul McBeth, ‘IRD’s business transformation project to come in under budget’, *NBR* (online), 11 November 2015 <http://www.nbr.co.nz/article/irds-business-transformation-project-seen-coming-under-1-billion-b-181435>. In fact, the programme is ahead of schedule and may be completed in 7 years.
[116] Inland Revenue, above n 114.
[117] Huang and Elliffe above n 18, 304.