VICTORIA UNIVERSITY TAX WORKING GROUP

Session three: Revenue Raising and Base Broadening 16 September 2009

The day:

- The framework in which to consider tax reform;
- Presentations from Len Burman, Arthur Grimes, and Treasury and Inland Revenue officials, followed by discussion, on:
  - Capital gains taxes;
  - Land taxes;
  - Other revenue raising options including the risk-free return method (RFRM), treatment of depreciation, environmental taxes, estate taxes, and additional resources for Inland Revenue.

Objectives of the Tax Working Group (TWG)

The TWG's focus is on the tax system as a whole but in the context of raising revenue to fund government expenditure activity. With the current fiscal situation, major reform, such as the Government's stated objective of aligning the corporate, income and trust tax rates at 30%, will need to be offset by other sources of revenue.

The TWG's role is to identify key issues for the Government if it chooses to restructure the tax system. The TWG needs to weigh up the pros and cons of various options for Government consideration and if appropriate, to identify options for change. All options, however, need to be considered as part of a broad reform package, and the impacts of various tax changes should be considered together.

Capital gains taxes (CGT)

Presentation by Leonard Burman on Burman and White (2009)

Capital gains are currently taxed in an ad hoc and inconsistent manner in New Zealand. Consequently, the treatment of capital gains in the tax system is inefficient, as it distorts saving and investment decisions, encourages tax shelters, adds unnecessary uncertainty, and reduces the tax base, requiring higher rates of personal income tax. The treatment of capital gains also makes the system more difficult to comply with and administer.

The current treatment of capital gains is also inequitable, because people with equal wealth and income can face different tax rates (38% tax for some, 0% for others) depending on how their income is received. Further, as the wealthy tend to hold higher-value assets, not having an effective CGT undermines the progressivity of the tax system and means the wealthy pay less tax on their total income than the less well-off.

Common arguments against a more comprehensive and consistent CGT are not that strongly supported by evidence. While it is argued a realisation-based capital gains tax creates strong incentives to hold assets and defer the tax liability, evidence of this effect is mixed, and US data suggests it is a limited problem. An accrual CGT would not create lock-in incentives. Similarly, an accrual tax does not change incentives for risk taking. Although a CGT may double-tax savings, this provides an argument for a shift to consumption tax instead of income tax, rather than for the continued preferential

treatment of only some returns to saving. Finally, as New Zealand's corporate tax is integrated with individual income tax through the imputation system, the double-taxation of company shares would not be a significant problem in New Zealand because of the imputation of tax credits to shareholders against tax paid at the company level to the extent that company profits are paid out as dividends.

Two possible capital gains tax design options for New Zealand could include:

- A hybrid approach that taxed listed shares and unit trusts on an accruals basis, and imposed a RFRM tax on other assets
- Applying a realisation-based CGT to all property, and to allow capital losses to be offset against the tax on gains. There would be a number of transitional issues to consider with this approach, together with any distortions created by exemptions, and tax treatment at death.

Despite some practical difficulties, a capital gains tax would improve system efficiency, raise revenue, be progressive, and it could pay for other tax cuts.

Treasury Presentation

Treasury said that a conservative revenue estimate for a realisation-based CGT on residential property (excluding owner occupied property), at current personal income tax rates was approximately $1.5 billion per year. This is a long-term revenue estimate and would take a period of time to be fully realised depending on transition rules, A CGT would nearly offset the cost of alignment of other rates at 30%. Given the distribution of gain making assets, a capital gains tax would improve the progressivity of the tax system, and a CGT would improve the efficiency of the tax system by more comprehensively taxing economic income. The impacts of lock-in, loss ring–fencing, and design and transitional issues, should not be overestimated. The primary question is whether a CGT, in conjunction with personal tax changes, could lead to overall efficiency and fairness gains despite some mechanical issues.

Inland Revenue Presentation

Inland Revenue commented that design issues are important, and the merits of a CGT need to be judged according to what would be likely to be implemented. If a CGT were to be introduced, a comprehensive accrual-basis tax is not viable. Taxing certain gains on accrual (e.g., gains in shares in listed companies) and others on a realisation basis (e.g., gains in unlisted companies) is likely to be inefficient. In this example, it would encourage firms to delist. The only feasible option is a realisation-based CGT. While there are some benefits in theory from a more comprehensive treatment of capital income, in practice, lock-in, ring fencing, and the treatment of losses are likely to mean that a CGT reduces rather than increases economic efficiency. A particular concern is the treatment of housing. A realisation-basis tax on owner-occupied housing could have important lock-in effects that would have unattractive consequences such as discouraging labour mobility. The likelihood would be an exemption for gains on a principal residence. The practical effect of introducing a CGT which applies to other uses of land but not owner-occupied housing is to add to distortions to land-use decisions. This is likely to reduce not increase economic efficiency. On equity, a CGT would increase income tax paid by upper-income earners, but may cause difficulties if owner-occupied property is excluded as the tax would discriminate in its favour. Inland Revenue noted that a capital gains tax may increase administration and compliance

costs. On balance, Inland Revenue argued that the advantages of a real-world CGT would not outweigh its disadvantages.

Discussion

Although an accrual-based CGT has several advantages, no other countries have adopted this form of a capital gains tax due to the practical difficulties involved.

If owner-occupied property is to be exempt from a CGT, this raises incentives to invest in owner-occupied property, and adds complexity to the system relative to a more comprehensive capital gains tax. This would reduce the integrity of the system and revenue. This problem might be avoided in some instances by allowing a limited exemption for owner-occupied property (e.g. a level of gain on owner-occupied property), or by clear definitions and avoidance provisions.

There is a lack of reliable information on capital gains in New Zealand because they are not generally declared. In Australia, CGT revenue in 2006/07 was $17 billion, despite the significant exemptions and preferential rate treatment for capital gains in the Australian system. The Australian data may not provide an accurate basis for assessing potential CGT revenue in New Zealand as it would include different investment levels in shares and other non-property assets.

Although the introduction of a more comprehensive system of capital gains taxation in New Zealand would improve integrity, avoidance opportunities would continue to exist with a capital gains tax. These could include sheltering of income in companies, and loss manipulation. Lock-in effects could be a problem - and some group members noted that this impact could be more severe given New Zealand's high levels of investment in real estate. Others thought lock-in would not be of major concern, and could be addressed, to an extent, through the design of the tax.

A capital gains tax would be highly progressive, given the distribution of gain-making assets across income deciles. However, given this, there may be mobility concerns with the introduction of a CGT, with higher income people having a potential incentive to leave New Zealand. The group generally agreed that if a CGT is introduced, capital gains should be taxed at personal income tax rates.

Officials should undertake further work on the economic efficiency of taxing capital gains to both risky and non-risky assets, and the impact of a CGT on savings.

An alternative option to partially address problems in the current system could be to exempt the inflation component of interest income from taxation rather than to implement a more comprehensive CGT. However this would be inconsistent with the inflation treatment of other forms of taxed income.

Land taxes

Presentation by Arthur Grimes on Coleman and Grimes (2009)

Land taxes are efficient as they tax an immobile factor. A property tax (which includes the value of improvements to land as well as land values) is less efficient. New Zealand has relatively low use of land and property taxes compared to other countries.

If a land tax is introduced, the value of land will face a one-off fall. Landowners will face a loss in the value of their property, while prospective buyers will benefit from not requiring such large deposits. A land tax would be likely to cause home ownership rates to rise slightly, and gross debt to GDP and net foreign assets to GDP ratios to fall due to lower foreign borrowing.

As the taxable land base (excluding government-owned and conservation land) is around $460 billion, a 0.1% rate would raise $460 million per year before the fall in land values. Excluding agriculture and forestry land and owner-occupied land, this revenue would be reduced to $160 million a year (before the fall in land values). The average farm's land is valued at $1 million and average residential land at $200,000.

A group that would be disproportionately affected by a land tax are retired people as they tend to hold more land, and would benefit less from other tax reductions. The group was interested in options that might improve the progressivity of the land tax without undermining the features of a flat-rate land tax that made it attractive from an efficiency perspective. A fixed rebate per hectare was suggested as a possibility, as this would reduce the impact of the tax on land-extensive owners, and lower value property would have a lower effective tax rate relative to higher value properties of the same size.

Officials' Presentation

Officials commented that a comprehensive single-rate land tax is efficient, as the supply of land is inelastic. A land tax will affect the price of land, rather than land use decisions. It is also efficient as it brings foreign owners of New Zealand land into the tax base.

On average, land holdings are broadly proportional to incomes. Therefore a flat-rate land tax would also be broadly proportional. However, the burden of the tax is determined by the value of land holdings, not income, and would be borne by those holding land at the time the tax was introduced.

There were two main concerns with the tax. First, if levied at a high rate (say 1%), it will cause a larger fall in land values, which could mean that people with highly-geared properties could end up with negative equity. The lower the rate applied to land values, the lower would be the fall in land values, and the liquidity cash-flow problems caused for tax payers would be less acute. Second, there was the horizontal equity concern that the tax fell on the wealth of only those who had wealth in one particular form (i.e., land).

A well-designed land tax would have low administration and compliance costs, although some thought will need to be given to collection methods and valuation. It would have a high degree of integrity, as it is hard to avoid. Revenue integrity issues could occur if different rates, or a narrow base, were applied. Similarly, uncertainty or frequent changes in the rate or base could reduce the efficiency of the tax.

Discussion

There was general agreement within the group that base broadening is critical in the longer-term to avoid large increases in personal income taxes and GST, and that the TWG needs to look for more sustainable long-term tax bases. The immobility of land is

a critical advantage for this kind of tax. However, although land is immobile, the value of land may change, affecting revenue derived from the tax.

The group agreed that it was critical that if a land tax was introduced the same rate was applied across all land types.

The group queried the impact of the drop in land values on highly-geared households, and insolvency. Officials commented that land is only a part of the value of property (approximately half of a property's value on average), so the relative drop in the total value of the property as a result of the land tax will be smaller (the drop in value of the property would be relative to the proportions of land and improvement values). The group agreed that this impact of a land tax should be considered further.

The group queried whether land tax paid would be allowed as a business expense deduction; and if so, whether the deduction would also be extended to private individuals. There was concern that allowing some deductions, such as for businesses, leads to a risk of reclassification of land or property as for a business in order to be able to make deductions. But land tax would be a normal business expense and Inland Revenue argued that not allowing this as a deduction could potentially be distorting.

A question was raised about the extent to which land taxes would address concerns about owner-occupied housing and the effectiveness of monetary policy for real estate bubbles. Officials stated that a land tax would not address future price bubbles at all as the tax would simply result in a one-off reduction in the existing value of land at the time the tax is introduced.

Comparisons between capital gains taxes and land taxes

Broadly, implementing a more comprehensive system of capital gains taxation would extend an existing tax base (the income tax base) to include capital income in taxable income; whereas a land tax involves the creation of a new base of tax. They would both increase tax rates in an area (particularly land) that is currently untaxed, and the bases overlap to some extent. Therefore although they may have some similar effects they are not necessarily substitutes for each other.

A comprehensive land tax is likely to be easier to implement, comply with and administer than a CGT. The integrity of the tax system could be improved by the adoption of either; although a land tax is likely to have a higher degree of integrity, particularly if the CGT is restricted to certain types of assets. In relation to vertical equity, a land tax is broadly proportional, whereas a CGT would be highly progressive; however the land tax is a one-off tax on existing wealth in the form of property, which compromises its horizontal equity relative to capital gains taxes.

Other base broadening and revenue raising options

Risk free return method (RFRM)

The group discussed the possibility of applying an RFRM tax to rental property as recent data show that tax revenue from the approximately $200 billion rental property sector is negative and has trended downward since the introduction of the 39% tax rate in 2000. There was general agreement that the glaring hole in the current tax system is the rental property sector, and that there are efficiency and equity problems with the

different treatment of savings in the form of bank accounts, and savings in the form of rental property.

Under an RFRM tax, rents from land would not be taxed, and other expenses relating to the investment would not be deductible, but a risk-free rate of return would be applied to the net equity in the property, and included in taxable income. There is a spectrum of real property over which the RFRM could be applied. If the base it applies to is broader than rental housing, the tax would be more efficient.

The group generally agreed that the option to establish an RFRM on rental property depends on whether a CGT is adopted. If a capital gains tax is not the preferred option, the TWG considers that the RFRM for rental properties is an option worth considering.

Issues raised by the group for further consideration in relation to the RFRM included:

- If an RFRM method is introduced there is a possibility that rents will increase, which impacts people on lower incomes;
- Under an RFRM people will be taxed even if they make losses;
- Applying the RFRM method only to rental or investment properties further increases the incentive to invest in owner-occupied housing.

Doubts were expressed as to whether or not rental housing and commercial buildings did depreciate. A question was raised as to whether there should be any depreciation deductions for these buildings. Allowing depreciation on buildings costs about $1.3 billion in forgone tax. It was noted, however, that some buildings, for example, industrial buildings, will in fact depreciate. Officials noted that the UK allows depreciation deductions for industrial but not other buildings.

An alternative option in relation to rental property would be to ring-fence losses to preclude offset against other income. Officials noted that previous ring-fencing regimes have proven reasonably easy to circumvent. It was also noted that the lack of tax attributable to rental investments is not limited to properties that are funded by debt.

Other options to increase revenue

A proposal for base broadening is to require building owners that claim depreciation to pay tax on any gains made when the building is sold. The revenue from this is hard to estimate. A possible variant to this would be to allow depreciation only against those buildings which reduce in value, such as industrial buildings.

The group concluded that environment and excise taxes were different from other taxes as their primary aim is not to effectively raise revenue to fund government spending, but to address other issues. Hence they are outside the TWG’s scope.

Other revenue raising options discussed included:

- Removing the depreciation loading on new assets - estimated at $0.5 billion in 2013.
- Removing the Kiwisaver tax exemption for employer contributions - estimated revenue of about $170 million per annum.
- Estate or inheritance taxes - these were ruled out because of mobility effects with the absence of these taxes in Australia, and the issue of double taxation.
- A cash-flow tax - this will be considered in more detail in the next TWG session.

The group also discussed the possibility of increasing the funding available to Inland Revenue to enforce the tax system, and to increase auditing activity. Overseas evidence, and Inland Revenue estimates, indicate that there are large returns to automated systems which can identify anomalies and in the tax system. The TWG broadly agreed that this is worth pursuing, and should be considered in its final report.