Capital gains tax
The New Zealand case

ROBIN OLIVER

New Zealand does not have a general capital gains tax, nor does it levy tax on inheritances. This makes New Zealand unusual among member countries of the OECD. We inherited our lack of capital gains taxation, along with most of our other legal and constitutional framework, from the English. But, in contrast with other countries (the United States, United Kingdom, Canada, and Australia) with a similar inheritance, we have retained an income tax that does not include capital gains in the taxation base. This paper, therefore, uses New Zealand as a sort of case study of what life is like when capital gains are not taxed. I comment on this from my personal perspective, which is that of someone who was a tax practitioner and is now a tax enforcer and a tax-policy adviser.

As a general rule, capital gains in New Zealand are not income for the purposes of our income-tax system. Indeed, our courts have held that our income tax law does not even recognize the concept of capital gains. In our law, capital gains are not exempt or untaxed

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The views expressed in this paper are those of the author and not necessarily those of the New Zealand Inland Revenue Department or of the New Zealand Government. Note will be found on page 87.

income; they have no legal recognition. This means, for example, that there is no requirement to apportion interest expenses to the derivation of taxed income and untaxed capital gains.

Nevertheless, our income tax legislation (the Income Tax Act 1994) includes in taxable "income" many forms of gain that, in the absence of specific legislation, would generally be considered capital gains. Each such provision has its own history. Very broadly, since the income tax was first introduced in New Zealand in 1891, our Parliament has considered it necessary to prevent people from characterizing otherwise taxable income as untaxed capital gain. The result is detailed and often complex legislation, as described below.

The tax regime in New Zealand is not easily classified. On one hand, we have no explicit capital gains tax. On the other hand, we include in taxable income many items that, in other jurisdictions, would be treated as capital gains. In other words, New Zealand does not have an explicit capital gains tax but taxes some capital gains as conventionally defined.

In my view, New Zealand's treatment of capital gains is due to the fact that any income-tax system that leaves all capital gains tax-free is essentially unworkable. On the other hand, I am not aware of any income tax system that taxes all capital gains under all circumstances. The issue, therefore, is the extent to which capital gains are taxed. Different countries have positioned themselves at different points along a spectrum from fully untaxed to fully taxed. New Zealand is near the untaxed end of the spectrum. However, the spectrum is not one-dimensional. Depending on the type of assets under consideration, New Zealand can be located near the fully taxed end of the spectrum. Debt instruments and certain overseas equity holdings of residents are examples of these asset types. In these cases, New Zealand's legislation can tax all capital gains on a full accrual basis.

Bearing these points in mind, this paper focuses on the effects of a tax system that does not tax capital gains explicitly. One of the most important conclusions to be reached is that conditions in New Zealand totally refute Professor Herbert Grubel's claim that: "If the capital gains tax were abandoned completely, many government employees, and private sector tax accountants and lawyers could be re-employed to produce goods and services valued by society more than the enforcement and manipulation of the tax code" (Grubel 2000: 30).

As an experienced accountant and lawyer, I have found that, even in the absence of a capital gains tax, many people are employed both in manipulating and enforcing tax legislation. Often the main job of these people is specifically to deal with problems of defining and enforcing the border between taxed income and untaxed gains that is due to the very absence of the capital gains tax.

Simplicity has not been the outcome of a lack of capital gains tax in New Zealand. Nor, is there much evidence to suggest that the absence of taxes on capital gains has had a marked effect on investment, capital markets, and overall economic performance. A possible but unlikely exception here is the propensity for New Zealanders to hold their wealth in the form of real property. From my perspective, the most marked effect of not having a specific capital gains tax has been to introduce a host of inconsistencies and complexities into our income-tax rules.

In the remainder of this paper I will focus on the way in which the absence of capital gains taxes has created incentives to change behaviour in order to reduce overall tax obligations. I will also discuss how efforts of the government to reduce such incentives have resulted in illogical and inconsistent policies, which turn out to be resistant to improvement.

Personally, I am neither for nor against a capital gains tax in New Zealand. The issue requires a detailed weighing up of arguments for and against such a tax. However, as my analysis will show, for those who oppose all capital gains taxation, New Zealand's experiences illustrate that the grass is not always greener on the other side of the fence.

New Zealand income-tax law

New Zealand has two main forms of taxation, the income tax and the Goods and Services Tax (a VAT). The income tax is levied uniformly on all personal, business, and investment income. There is no separate set of tax rules for the corporate or any other sector.

New Zealand's income tax legislation leaves the term "income" undefined. The judiciary has instead provided the operational definition of income. The judiciary turned to trust law and other precedents for the definition of income. In general, this meant that most increases in the value of assets, other than trading stock, were excluded from the tax base. This outcome relied on concepts from trust law that differentiated the interests of the life tenant (entitled to income) from the interests of the remainder man (entitled to capital and so to the realization of capital assets of the trust).

Our assertion that New Zealand has no capital gains taxation rests on these principles of trust law. It is obvious that the trust law is devoid of economic concepts and principles. As the New Zealand Royal Commission on Social Policy commented: "With hindsight it seems surprising that concepts of trust law were considered an appropriate substitute for a direct focus on economic efficiency and equity concerns in the raising of taxes" (New Zealand Royal Commission on Social Policy 1988: 450).

In practice, it is difficult to distinguish between income and assets. The Privy Council noted in *BP Australia Limited* v *FCT* that the distinction is "sometimes difficult to draw and leads to distinctions of some subtlety between profit that is made 'out of' assets and profit that is made 'upon' assets or 'with' assets" ([1964] AC 244 at 262).

An example of this difficulty can be found in the area of investment and financial intermediation. Thus, a mutual fund managing a portfolio of shares is usually taxed on profits from the sale of shares in its portfolio. The rationale for this interpretation is that the selling of shares is a normal part of the business of such an entity. A small investor holding shares directly, on the other hand, is not taxed on capital gains realized through the sale of shares. However, these general rules have been modified through rulings by New Zealand's Inland Revenue Department in relation to the operation of index funds. The Department has ruled that an index fund does not hold shares on revenue account and can make tax-free capital gains, mainly because its share purchases and sales are not part of a business but determined by the requirements of the index. This ruling provides a tax incentive for investments in passive rather than actively managed funds.

The poorly defined boundary between income and capital provides many opportunities for tax advisers and many problems for the revenue authority. In the case of trusts, the courts have decided that the increase in trust assets can be classified as income or capital according to the intention of the person who originally transferred assets to the trust. It is obvious that, in general, taxpayers will attempt to define profits as capital gains and consider all expenses deductible from profit producing revenues. For this reason, the tax authorities have been faced with the need to define as taxable income many items that would otherwise have been tax-free capital gains.

The following are some examples of how New Zealand has legislatively broadened what is included in taxable income.

Gains from the sale of personal property

The legislation taxes profits or gains from the sale of property where the taxpayer is a dealer in such property. Interpreted literally, this legislation would apply even where the property on which the profit was made was held for purposes other than dealing. However, the courts have restricted the provision to assets held for trading purposes. Thus, the provision does not make taxable what would normally be considered to be capital gains.

Legislation also makes taxable all profits or gains from the sale of property acquired for the purpose of sale. This means that shares acquired for their dividend yield give rise to untaxed gains, while those acquired for their capital yield do not. In practice, this distinction has given rise to lengthy case law, which sets out more precisely under what conditions property is considered to be acquired with the purpose of sale and, therefore, taxable; and under which it is acquired without the intention of sale and, therefore, not taxable.

Legislation has also made gains from profit-making undertakings or schemes taxable. However, the courts have interpreted this provision so strictly that it does not tax anything that would otherwise be considered a capital gain.

Land transactions

New Zealand income-tax legislation has detailed and complex provisions bringing many gains on land transactions into the tax net. This legislation was designed to counter the situation whereby land developers and builders claimed all of their income to be non-taxable capital gains so that developers and builders became in effect untaxed occupations. In broad terms, New Zealand taxes gains on the sale of land acquired with an intention of resale by land dealers, developers, and builders, including gains due to the rezoning, subdivision, or development of land. There are exceptions to these rules for private residences, business premises, and farmland.

Income from debt instruments

The difficulty of sustaining the traditional distinction between profits and capital gains is particularly acute with respect to debt instruments. If lenders can make a return that is taxable by way of coupon payments or tax-free by way of a redemption payment, they will always prefer the latter. In the United Kingdom, realized profits on discounts of financial instruments were made taxable profits as early as 1805. Since 1986, New Zealand has gone further and put a similar law in place, which taxes all gains from the holding of debt instruments as they accrue.

Foreign investment fund rules

New Zealand aims to tax the worldwide income of its residents, including income derived by offshore companies and similar entities. Since it is not possible to subject foreign entities to a national tax, New Zealand levies an accrued capital gains tax on all foreign portfolio equity investments. This rule does not apply to companies resident in Australia, Canada, Germany, Japan, Norway, the United Kingdom, and the United States. Non-portfolio gains are subject to controlled foreign company rules. These require the shareholders of subsidiaries to return as income their proportion of the profits of those foreign subsidiaries. The profits of foreign subsidiaries are calculated in accordance with normal New Zealand tax laws so that, for non-portfolio investments, capital gains remain tax-free.

The results

It is difficult to know what effect New Zealand's lack of a capital gains tax has had on her capital markets. The New Zealand stock exchange has not been noted for its high performance in recent years with a price index still below the high it achieved in October 1987. It is also worth noting that New Zealand's listed share prices are strongly influenced by non-resident investors who hold up to 40% of the value of total market capitalization. Such shareholders have been the marginal investors and, while they have played an important role in the determination of share prices, they tend not to be affected by not having to pay New Zealand's capital gains taxes. That is because, even if New Zealand had a capital gains tax, in most cases foreign investors would not be subject to such a tax under New Zealand's double-tax agreements.

There is also little evidence that the absence of capital gains taxes has encouraged entrepreneurial endeavours in New Zealand. The country's business expenditure on research and development and its post-war economic performance have been well below the OECD average. In 1997/1998, our business expenditure on research and development was 0.32% compared with an OECD average of 1.48% of GDP.

It is not clear what role New Zealand's tax system plays in the pattern of asset holdings by households. Direct equity is most favoured by the tax system yet it constitutes a very small proportion of household assets. Debt instruments and equity held through intermediaries are not tax-favoured to the same extent but constitute a much higher proportion of wealth. Average annual real capital gains on housing since 1960 have been around 1% while untaxed, imputed, annual real increases in housing income amounted to about 2% to 2.5%. The practice of not taxing imputed rental income is a feature of most tax systems and in New Zealand it is significantly clawed back by not allowing the deduction of mortgage interest.

For many years until the later 1980s, New Zealand experienced high rates of inflation, paid government subsidies on many investments, and controlled interest rates, which often were negative in real terms. It is likely that these conditions have played a greater role in setting the pattern of private investment than did the tax system. Similarly, the country's economic growth rates have probably been influenced more by inflation and other government policies than by the absence of a capital gains tax.

It has been argued that the absence of a capital gains tax creates a strong incentive for the excessive reinvestment of business profits, which erodes the tax base and causes the inefficient withholding of funds from potentially higher yields in other employment. There is no evidence that such excessive reinvestment of profits has taken place in New Zealand in spite of the absence of a capital gains tax. The average dividend yield of New Zealand's listed companies is about 5% to 7% annually, which is high by world standards. That high yield indicates that the lack of capital gain taxation does not lead to excessive corporate reinvestment. Smaller companies tend to distribute most of their available income to the owners.

The reasons for these high-dividend returns on business investment are likely to lie in the overall structure of the tax system, in particular, the fact that salaries are deductible from the business income-tax base and dividends carry credits for taxes paid at the corporate level.[1] Until April 1, 2000, the company rate was at 33% and equal to the top personal marginal tax rate so that there were no incentives to retain profits. In fact, because personal income-tax rates are progressive, a positive incentive exists to distribute rather than retain income whenever the effective personal income-tax rate is less than the corporate income-tax rate.

From April 1, 2000, New Zealand's top personal marginal tax rate was increased from 33% to 39%. The company and trustee tax rates remained at 33%. It is likely that this will lead to increased retention of profits. That will be balanced by the increased advantage from income splitting by making distributions to family members with low tax rates.

In general, however, it is the overall nature of the tax system, such as the rate structure and the manner in which dividends are taxed, that can lead the tax system to encourage excessive profit retention. The presence or absence of a capital gains tax seems peripheral.

Problems created by not taxing capital gains

The conclusion of the previous section was that the absence of a capital gains tax has not had an easily identifiable impact on the economy. Earlier, however, I described some of the complexities of New Zealand's income-tax legislation caused by not taxing capital gains. Why the legislative complexity in the absence of discernible impacts?

The main reason for the complexity of the tax laws is that the absence of a capital gains tax reduces the income-tax base and results in the following consequences. First, artificial boundaries are required between what is taxable and what is not taxable. Defining those boundaries leads to complex tax legislation. It also leads to policy inconsistencies and unintended incentives built into the tax structure. These problems cannot be resolved without moving closer to a concept of economic income and the consequent removal of the distinction between capital and the revenue it produces. Secondly, working on these distinctions is the life-blood of tax planners and a prime hunting ground for tax-planning schemes. The remainder of this paper considers these two issues by way of examples drawn from the New Zealand experience.

Structural problems created by the distinction between capital and income

The problems created by the need to distinguish between capital and income from capital can best be illustrated by the inconsistent tax rules affecting individuals' choices of investment in shares or bonds. This choice can be made directly or indirectly through an intermediary such as a mutual fund. The lack of a general capital gains tax has resulted in a series of rules that generally encourage direct over indirect investment and equity over debt instruments.

First, dividends are taxable as ordinary income. The problem of double taxation of corporate income is overcome by allowing the dividend recipient to get a credit for tax paid at the corporate level. However, when a company distributes to its shareholders a capital gain, no tax credit is available because no company tax has been paid. The end result is that the capital gains exemption provided at the company level is clawed back when the gain is distributed as a dividend. If, on the other hand, the shareholder holds equities directly and not through an intermediary company, the shareholder retains the benefit of tax-free capital gains.

Trusts are not subject to this dividend claw-back, so an investment made through a trust retains the benefit of tax-free capital gains. That clearly places trusts at an advantage over companies as an investment intermediary. In response, New Zealand legislation deems certain trusts to be companies subject to the dividend rules, which prevent the tax-free realization of capital gains to its owners. Trusts treated in this way solicit investments much as mutual funds do in North America. Although this particular treatment of trusts shores up the tax base, it creates a bias against the use of trusts and the financial intermediation they provide.

The same incentive against financial intermediation is created by the general common-law rule that profits from the sale of shares held in a managed portfolio are taxable as ordinary business income. This rule makes it impossible for most intermediaries to make capital gains even if they can distribute the profits tax free.

As noted above, capital gains made by index funds are not subject to the same rule. They are considered not to be trading shares and, therefore, capital gains are not seen to be arising from a taxable trading activity. It is clear that this special treatment of index funds creates incentives for investors to invest in them rather actively managed or ordinary passively managed funds. Such incentives cause economic inefficiencies and therefore are undesirable.

As a government policy adviser, I can say that there was never a deliberate intention to design a set of tax rules that exhibit the biases just noted: the discouragement of intermediation and the encouragement of passively over actively managed equity portfolios. These rules have arisen from the need to protect a tax base that is eroded by the failure to tax capital gains.

A second example of a problem caused by the lack of a capital gains tax involves share repurchases by the issuing company. Conceptually, a share repurchase is equivalent to the distribution of a dividend by a firm because both methods result in the transfer of corporate assets to shareholders. However, dividend payments are taxable while the capital gains realized through the repurchase of shares are not. This asymmetric tax treatment of company reserves distributed to shareholders introduces incentives to favour share repurchase over the distribution of dividends. Other countries deal with this issue by taxing share repurchases either as a dividend or as a capital gain. New Zealand does not have that option and had to adopt complex rules and somewhat arcane legislation. Under these rules, some taxpayers are taxed on gains they have not made, while others are not taxed on gains they have made.

Depreciation creates a further problem for New Zealand's tax system because it has no capital gains tax. It is well known that the depreciation of assets imposes an often unrealized decline in wealth on its owners and implicitly on the net income earned from the asset during the relevant period. Since New Zealand's income-tax system was based on the non-recognition of changes in asset values, the original income-tax system did not provide for the depreciation of assets in the calculation of tax obligations. However, soon after the initial legislation was passed, it was realized that the absence of depreciation allowances resulted in the over-taxation of business income. Consequently, Parliament corrected this mistake and passed legislation that allowed depreciation to be treated as a special allowance. Unfortunately, the use of depreciation as an allowance creates an asymmetry in a tax system that does not tax capital gains. Declines in asset values give rise to deductions while increases are tax-free.

Tax planning problems created by distinction between capital and income from capital

The preceding section contained a number of examples of special rules in New Zealand's tax code that were adopted to deal with perverse incentives stemming from the absence of a capital gains tax. These rules give rise to many opportunities to plan financial affairs for the avoidance of taxes by attempting to get all accretions to wealth on tax-free capital account and all expenditure on deductible revenue account. There are many, ingenious methods to achieve this; the following are a few examples.

The average salary earner has few opportunities to earn tax-free capital sums. One opportunity is a redundancy payment received upon losing a job. Traditionally, such a payment was considered a tax-free capital payment to the employee. Since in many circumstances such payments could be traded off for taxable salary, the New Zealand Parliament made redundancy payments taxable. However, payments for humiliation on redundancy have retained their tax-free status. As this opportunity has become more widely known, New Zealand employers have shown a tendency to ensure that redundant staff have been subject to increasing levels of humiliation.

In a similar way, employers have shown an increasing tendency to provide workers with capital payments to induce them to leave their previous occupations or to accept restrictive covenants, which limit their ability to work elsewhere. Courts have decided that such payments are not taxable. The apparent ability to substitute in this way tax-free for otherwise taxable remuneration has led the Government recently to introduce legislation to prevent these practices.

Another example of a practice that turns taxable income into non-taxable capital gains involved an international accounting firm, which received a lump-sum payment in return for leasing for very high rental payments floors of a commercial building. The receipt of the up-front lump sum offset the high annual rental payments so that in present value terms the net effect was a lease cut at prevailing market levels. The Privy Council held that the lump-sum payment was a tax-free capital gain, even though the firm then received deductions for its above-market annual rental payments.

Another, even more imaginative method for turning taxable income into capital gains involves the fact that New Zealand levies tax on the worldwide income of residents, including that generated through offshore subsidiaries. To avoid this tax on foreign income a New Zealand company can pay an unrelated non-resident bank a sum of money. In return for this money, the company receives the option to purchase, for a minimal amount, shares in a New Zealand subsidiary of the non-resident bank created especially for this purpose. The bank then invests the sum tax-free in a haven and eventually invests the capital plus tax-free interest in its New Zealand subsidiary. The New Zealand company then sells the shares that give it ownership of the foreign bank subsidiary and makes a tax free-capital gain.

Another practice for tax avoidance is used by very wealthly individuals who borrow funds offshore. The funds are used to invest in a New Zealand company. The loan is "back-ended" so that no payments are required until the loan matures, although accrued interest on the borrowings is deductible. The New Zealand company expends the funds on a high-risk venture (in which the lender also has an interest), giving rise to further tax deductions. The loan plus interest is repaid at maturity as investors exercise an option to put their interest in the venture entity for the principal plus interest. The profit is a tax-free capital gain. The investor, for an up-front investment, receives a return by way of substantial tax deductions.

There are many other examples I could present to illustrate the sophisticated methods used by New Zealanders to turn income into capital gains. Suffice it to note that human ingenuity and the profit motive are likely to come up with new schemes, whatever efforts are made by the tax authorities to prevent the abuse. This dynamic process and the cost of monitoring it certainly are highly undesirable and inefficient consequences of a tax system that fails to tax capital gains.

Proposals for reform in New Zealand

The structural problems that the lack of tax on capital gains poses for our income tax system have not gone unnoticed. A number of reviews of the tax system have considered the extent to which New Zealand should tax such gains.

In 1966, the Government established a committee of independent experts (the Ross Committee) to undertake a comprehensive review of all aspects of central government taxation in New Zealand. The committee reported in October 1967 (Government of New Zealand 1967). It noted that there was a strong justification for taxing realized capital gains, although it considered the issue needed further study and any reforms in this area should follow implementation of other reforms such as lower marginal income-tax rates.

In 1982, a task force on tax reform reported (New Zealand Government 1982). It concluded that, although there was no reason in principle not to tax capital gains, it did not recommend the introduction of a capital gains tax at that time. The task force's views seemed to be influenced by its view that introducing a capital gains tax during a period of high inflation, as then prevailed, would create more problems than it would cure.

In 1989, the then Labour Government did propose the taxation of capital gains, along with across-the-board indexation of the income tax base (New Zealand Government 1989). With the defeat of that Government in a General Election late in that year, the proposals did not proceed.

In 1998, the then Government established a "Committee of Experts" to review a number of aspects of the tax system, including compliance costs and how to make the tax system more robust against avoidance. The committee reported in December 1998 (New Zealand Government 1998). Whether capital gains should be taxed was outside the Committee's terms of reference. The committee did comment, however, that the benefits of a capital gains tax would depend on the proposed package of taxation reform of which it was a part.

Finally, the Labour-Alliance Coalition Government formed at the end of 1999 has stated that it will not introduce a capital gains tax in its first term of office. The Government has announced an inquiry into the tax system. Questions that will be posed to the Inquiry include whether the tax system can be made fairer and whether the income-tax base should be broadened. This may involve consideration of the issues surrounding the taxation of capital gains.

Conclusion

This paper has canvassed the problems posed for New Zealand's tax system by the absence of a general capital gains tax. Undoubtedly, if we had a capital gains tax, the paper would have canvassed the problems posed by having such a tax. Certainly, designing an efficient capital gains tax raises a number of issues for policy makers. They include the following:

- whether the tax base needs to be indexed for inflation;
- whether gains should become taxable upon accrual or realization (or disposal)
- the range of capital gains to which the tax is to be applied, especially whether is should include private residences;
- the treatment of capital losses;
- the appropriate rate of tax.

The basic issue in practice is not whether or not, but the extent to which, capital gains should be taxed. The extent should be chosen after careful analysis of what optimizes fairness and efficiency, all within the context of each country's tax structure and system. There is probably no unique and perfect design for such a tax system.

However, I would assert, after my long experience with New Zealand's tax regime as a private consultant and government adviser that the best possible system is not one that simply excludes capital gains from taxable income. For practical, if not economic, reasons, nor would an optimal tax system be likely to include the full taxation of capital gains on an accruals basis.

Note

1 Small, family-owned companies can pay out dividends from income on which no company tax is payable (such as capital gains) tax-free under the qualifying company rules.

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