

**Taxing Capital Gains in New Zealand:
Assessment and Recommendations**

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1. Introduction

One of the most vexing and contentious issues in taxation is the proper treatment of capital gains — the increase in value of an asset such as shares of company stock or a business.¹ In principle, under an income tax, capital gains should be included in the tax base as they accrue. In practice, if they are taxed at all, capital gains are almost always taxed only when an asset is sold (or “realised”) and generally at lower rates than other income.

By not taxing most capital gains, New Zealand is unusual amongst OECD countries.² Other OECD countries typically tax capital gains but at concessional rates compared with the taxation of other income. Australia’s capital gains tax rates, for example, are relatively high by OECD standards but even there the capital gains tax rate is only half the rate applied to other income (giving a top capital gains tax rate of 23.25%).³

The argument for concessional taxation is that capital gains are different from other forms of income. Since capital gains typically accrue on risky assets, taxing them deters risk-taking, to the detriment of the economy. Another argument posited in favour of lower tax is that capital gains are eroded by inflation. Gains on corporate shares and unit trusts also represent income that has already been subject to company-level tax, making individual level taxation an inefficient double tax (although New Zealand’s imputation credit system would eliminate much of this distortion). And, finally, taxing capital gains discourages saving.

Taxing gains upon realisation creates special issues. It creates a strong incentive to hold onto appreciated assets to avoid the tax—the so-called “lock-in effect” — an inefficient distortion in financial markets. Moreover, capital losses are generally only deductible against capital gains. Allowing full deductibility of losses would create almost

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¹ This paper develops further some of the arguments for a capital gains tax developed by Burman and White (2003) for New Zealand and Burman (2009) for Australia. We are grateful to Matt Benge, Norman Gemmell, and John Shewan for helpful comments and discussions. The paper is work in progress.

² OECD (2000), (2006), (2007).

³ See Ernst & Young (2008). This 50% discount on capital gains appears to be under evaluation by the Henry Review of Australia’s future tax system (Martin (2009)).

unlimited ability to shelter other income from tax since an investor could purchase offsetting short and long positions in assets and then realise the position with the loss to shelter other income while taking on no risk (or, indeed, making a meaningful investment). Even when such strategies are limited by statute, diversified investors could achieve similar results by selectively realising assets with losses and holding those with gains. However, with loss limits, full taxation of gains may penalise capital gains compared with other less risky investments.

Critics counter that concessional taxation of capital gains is unfair. It favours taxpayers who earn their income in the form of capital gain over those who earn income in the form of interest, rents, or royalties. It favours wealthy taxpayers over those less fortunate (because high-income people are much more likely to have capital gains than those with modest means).

Furthermore, critics complain that concessional taxation of gains encourages tax avoidance, which is unfair, because aggressive (generally high-income) taxpayers pay less tax than others, and inefficient, because the financial wizards, lawyers, and accountants who design tax avoidance schemes could otherwise be doing productive work and because such schemes often involve investments or business strategies that would make no sense without the tax savings.

This paper considers the potential for taxation of capital gains and losses in New Zealand. We begin by outlining the policy problems created by New Zealand's existing hybrid regime – an incoherent mix of taxation based on accruals, realisation, and imputed return, combined with a large class of exempt assets. Given the common historical origins of the Australian and New Zealand income taxes, the very close links between the two economies, and the concurrent reviews of the tax and transfer systems in each country,⁴ we also summarise the Australian capital gains tax regime. We then discuss conceptual issues and empirical evidence related to the taxation of gains and makes recommendations about how a reformed capital gains tax in New Zealand might operate.

⁴ The review of Australia's tax system is called "Australia's future tax system" and is now known as the Henry Review, after the Chair of the review panel, Dr Ken Henry, the Secretary to the Australian Federal Treasury (see <http://taxreview.treasury.gov.au>). The review of New Zealand's tax system is called the Tax Working Group and is chaired by Professor Bob Buckle of Victoria University of Wellington (see <http://www.victoria.ac.nz/taxworkinggroup>). The two reviews are due to report to their respective governments in December 2009.

2. New Zealand's hybrid regime for taxing capital gains and losses

As we noted in 2003, the current hybrid set of New Zealand tax rules is far from ideal.⁵ For much of its life, the New Zealand income tax has taxed some appreciation in the value of property. Indeed, at least 25 kinds of assets and transactions are presently defined as taxable - some on realisation, others on accrual or an equivalent, and still others based on imputed return.⁶

But unlike other countries with a United Kingdom income tax heritage, including Australia, Canada, and the UK itself, New Zealand has never enacted a general capital gains tax. The result is a grab bag of income and deduction rules accumulated over more than 100 years. Some rules were developed by judges, often drawing on inappropriate trust law concepts.⁷ Others were hurried and unnecessarily complex responses by Parliament to economic events.⁸ And some were the result of more principled tax policy analysis and consultation by government.⁹ But even some of these latter provisions may not represent appropriate tax policy for a small, open economy in 2009¹⁰ and in the medium-term.¹¹

By 1989, following five years of extensive reform, New Zealand had considerably expanded the income tax base and slashed tax rates. The result, according to the OECD, was an income tax system that was “probably the least distorting in the OECD.”¹² The same year that it received this OECD plaudit, the Government released detailed proposals to rationalise the rules for taxing income from capital, including some of the real gain on the sale of personal residences, and to index the whole income tax base for inflation.¹³ However, the government's proposals to develop more coherent and certain rules for

⁵ Burman and White (2003) pp. 356-57. The detail of some of the problems from a policy perspective is analysed in Oliver (2001) and Holmes (2001).

⁶ Holmes (2001) p. 383.

⁷ New Zealand, Royal Commission on Social Policy (1988) p. 450. The chair of the Royal Commission was the eminent tax lawyer and judge, Sir Ivor Richardson.

⁸ The 1973 land transaction amendments made in s. 88AA Land and Income Tax Act 1954 in response to escalating house prices.

⁹ See, for example, White (2009) for analysis of the political economy of New Zealand tax policy design, implementation (in 1984-1988) and sustainability of four broad-base, low-rate income tax reforms: the income taxation of private savings; company tax base broadening and dividend imputation system; the taxation of financial arrangements; and, the international income tax base-broadening for residents.

¹⁰ For example, the inability of one small country acting alone to promote capital export neutrality, and changes in “the world of international finance, investment and production” over almost 20 years from 1988, were two major justifications for announcing a change in direction away from conceptually correct rules for taxing income on outward direct investment in 2006 (for further discussion, see White (2009)). A government discussion document announced support for an exemption for the offshore active income of controlled foreign companies (Cullen and Dunne (2006) pp. 7-15) and legislation that has just passed its final stages in Parliament, among other things, introduces a tax exemption for the foreign active income of controlled foreign companies and exempts most foreign dividends received by New Zealand companies from tax.

¹¹ For some of the economic, social and demographic changes that pose medium-term tax policy challenges and opportunities for the New Zealand tax system as the New Zealand economy becomes increasingly integrated into the global economy and, in particular, the Australian economy, see New Zealand Treasury (2009).

¹² OECD (1989).

¹³ Caygill (1989).

taxing gains and allowing deduction for losses, based on standard tax policy criteria of equity, efficiency, and certainty, were shelved when the Fourth Labour Government was defeated in elections in 1990.

In 2001, the Fifth Labour Government appointed an expert committee to undertake a general review of the New Zealand tax system. The McLeod Committee concluded that New Zealand should not adopt a general realisations-based capital gains tax because it believed that this type of tax “would not necessarily make our tax system fairer and more efficient, would not lower tax avoidance and would not raise substantial revenue that could be used to lower rates. Instead, any such tax would be more likely to increase the complexity and costs of our tax system. The experience of other countries (such as Australia, the UK and the US) supports that conclusion.”¹⁴

The McLeod Committee favoured a continuation of the *ad hoc* New Zealand approach of dealing with capital gains issues as they arose. To address the problems caused by the disparate taxation of different savings entities at that time, it proposed the risk-free return method of taxation.¹⁵ Six years later, in 2007, the government chose to achieve “coherence” in this area by broadly aligning the rules for taxing gains of certain collective investment entities arising on the sale of shares in New Zealand companies and Australian listed companies with the non-taxation of capital gains often arising from the sale of shares by individuals. This expansion of capital-gains exempt assets through the portfolio investment entity regime illustrates a danger of adopting an incremental approach to reform issue by issue. Each reform may be logical in relation to a design feature, or even several design features, of the existing income tax but not help produce coherency in the tax system as a whole.¹⁶

Furthermore, the incremental or pragmatic approach to capital gains reform has not been very effective at addressing the efficiency, equity, administrative and compliance cost problems, and the uncertainties that exist today, some of which have a long history. Here are some current examples:

- Land. There are no efficiency or equity arguments that can justify taxing capital gains on the sale of land based upon a taxpayer’s purpose at the time of acquisition and yet the New Zealand income tax has done that since 1916. The 1973 amendments added very complex realisation rules and exceptions. Broadly, the rules now tax gains on the sale of land acquired with an intention of resale, certain land acquired by land dealers, developers, and builders, and certain gains arising from rezoning, subdivision, or development of land. The rules also contain

¹⁴ McLeod (2001b) p. 28.

¹⁵ McLeod (2001b) p. 29. The McLeod Committee also released an issues paper that, among many other things, raised the possibility of taxing the net equity component of owner-occupied and rental houses using a risk-free return method (McLeod (2001a) p. 40-42). In its final report, the committee recommended the government not proceed with the proposal in the absence of a reasonable prospect of public support (McLeod (2001b) p. 32).

¹⁶ For analysis of the political economy reasons for New Zealand’s broad-base, low-rate income tax reforms of 1984-1988 being less enduring than the broad-base, low-rate consumption tax reforms of 1984-1988, see White (2009).

numerous exceptions, including for private residences, business premises and farm land. They are not a coherent set of rules that are easy for taxpayers to comply with and IRD to administer (for detail see Prebble (1986), Holmes (2001), Oliver (2001), Harris and Smith (2004a and b)). Indeed, the IRD has had three years of additional funding to June 2010 “to address risks associated with property, particularly property speculation” but will require further funding to determine whether more than 7000 people who have bought and sold three or more properties over a period of four years (New Zealand, Officials from the Inland Revenue (2009)) owe tax under these very complex rules.

- Shares. The rules for taxing gains on shares are more complex than they have ever been, depending upon whether they are shares in New Zealand companies, Australian listed companies, Australian unlisted companies, or other foreign companies, and whether they are held by portfolio investment entities or by a dealer in shares or were acquired for the purpose of resale. The dealer and purpose provisions in relation to shares date back to 1951.
- Tax shelters. One result of the current New Zealand hybrid regime for taxing capital gains and losses, with a large class of exempt assets, is that tax planners can readily devise tax shelters that ensure that gains are tax-free and expenditure is deductible (Oliver, 2001). Under current law, for example, many gains derived in respect of intellectual property are untaxed. While developing intellectual property, like a trademark, the New Zealand firm can claim deductions for certain expenditures but not be taxed on the gain on sale of the intellectual property. If the sale were to an associated party offshore, that party could license the New Zealand firm to use the trademark for royalties that would be deductible to the New Zealand firm with the only New Zealand tax collected being a small withholding tax.

3. Australia’s realisation regime for taxing capital gains and losses

In the early 1980s, the Australian income tax rules for taxing capital gains and allowing deductions for losses had some close parallels with New Zealand legislation, in some cases enabling Australian case law on the Australian legislation to help interpret the similar New Zealand section (Harris and Smith, 2004a, pp. 361, 373).

In 1985, Australia changed course. It introduced a general realisation regime for taxing capital gains and losses. As we noted in 2003, the Australian Treasurer’s revenue projections from the prospective Australian realisations capital gains tax were far too low. By the third year of its operation, capital gains tax revenues leapt to more than 20 times the year five projection.¹⁷ Revenue from capital gains does fluctuate but it is always a substantial contributor of revenue. The official estimate of capital gains tax payable on the net capital gains of taxable individuals, companies and funds in the latest year of statistics

¹⁷ Burman and White (2003), p. 367.

was \$17.3 billion (2006-2007). About 61.4% of the total capital gains reported in taxpayer schedules were sourced from share transactions.¹⁸

In Australia, as in most countries that tax capital gains, capital gains and losses are only realised for tax purposes when an asset is sold. Gains or losses on assets held by individuals for at least 12 months are considered long-term and subject to a 50% exclusion. Since the top income tax rate is 46.5% (including a 1.5% Medicare levy), the top effective tax rate on long-term capital gains is 23.25%. Earnings in superannuation (pension) funds are subject to a flat 15% rate, but long-term gains and losses are subject to a one-third exclusion, yielding a top effective tax rate of 10%. Companies are subject to tax on net capital gains at a 30% tax rate with no exclusion. The corporation income tax is integrated with the individual income tax so the company tax paid is imputed to shareholders to the extent that profits are paid out as dividends and the credit may be claimed against individual income tax.

Losses are deductible against capital gains, but net capital losses (losses in excess of capital gain) are not deductible against other income. Instead, they may be carried over indefinitely and deducted against future capital gains.

Australia exempts certain capital gains from tax, including gains on a principal residence and gains on assets acquired before 20 September 1985, when the capital gains tax was first introduced.¹⁹ Rollovers are allowed for certain gains, including on assets transferred at death, as a result of a court-ordered divorce decree, and when a company is acquired in exchange for shares in the acquiring company. Gifts of capital assets trigger a realisation of gain for tax purposes to the donor.

If New Zealand were to introduce general capital gains taxation, key choices would involve whether to follow Australia in adopting a realisations basis, whether to exempt some assets such as the primary residence, and what rate of tax to set.

4. How should capital gains be taxed?

A first issue to consider is the appropriate baseline for taxation—income versus consumption tax. Under an ideal income tax, capital gains are taxed as accrued, whereas under a consumption tax, gains would be untaxed. Nonetheless, some have argued that capital gains should be granted concessional status under an income tax—in part based on the desirability of a consumption tax base. In this section, we show the fallacy of that argument and then discuss how capital gains should be taxed under an income tax.

¹⁸ Australian Tax Office, *Taxation Statistics 2006-2007*, p. 78 available at <http://www.ato.gov.au/corporate/content.asp?doc=/Content/00177078.htm>.

¹⁹ Originally, the basis of capital assets was indexed for inflation, but that provision was replaced with the partial exclusion on 20 September 1999. Taxpayers holding capital assets at that date could choose between the exclusion and indexing the basis for inflation up to that date.

4.1 Taxation in a pure income or consumption tax

Under a pure Haig-Simons income tax, capital gains would be taxed as ordinary income as they accrue, like interest payments, not as realised, because the increase in asset value represents an accretion to wealth. Accrued capital losses would be immediately deductible. For logical consistency, income and expense should be indexed for inflation. Thus, only the real gain or loss on the asset should be included in income. Interest expense would also be indexed, so only the excess of interest above inflation would be deductible. This is important because, otherwise, the taxpayer could gain pure arbitrage profits by deducting nominal interest while only recognising real gains.²⁰

Alternatively, suppose the tax base were an R-based consumption tax.²¹ In this case, capital gains and other forms of capital income (rents, royalties, interest, and dividends) would be exempt from tax and interest expense would not be deductible. As in the pure income tax, because capital income and expense would be taxed symmetrically, taxes would not distort investment decisions.

There are advantages and disadvantages of each tax system. On the one hand, a consumption tax does not penalise future consumption relative to current spending and thus is not biased against saving and hence more efficient.²²

On the other hand, a consumption tax is less progressive than an income tax, because consumption declines as a share of income. In the United States, high-income households spend less than 40% of their incomes while those with very low incomes spend all of their meagre earnings and more.²³ Thus, consumption taxes hit lower-income households especially hard.²⁴

Moreover, even though an income tax entails a cost in terms of efficiency, it might be a less costly tool to achieve distributional objectives than other more populist measures such as trade restrictions or regulation of wages and employment.²⁵ In fact, as figure 1 shows, the pre-tax distribution of income in New Zealand is quite skewed in favour of high-income individuals. The top 10% of income earners reported almost 30% of income in 2006-07.

²⁰ To take a very simplified example, suppose the taxpayer could borrow at a 5% nominal rate to invest in an asset that is expected to pay a 5% annual capital gain. Suppose the real rate of return is 2% (inflation is approximately 3% per year). This investment would just break even before tax (and would not be undertaken if there were any transaction costs or risk associated with the capital gains asset). If gains and interest are treated the same way (either indexed or not), the investment would also just break even after tax. However, if nominal interest is deductible (5% per annum) while only real capital gain is taxable (2%), the investment would now be profitable after tax. The profit would equal tax on the 3% inflationary return. Thus, the asymmetric taxation of gain and expense makes an unprofitable investment profitable, distorting investment choices.

²¹ See Meade Committee (1978).

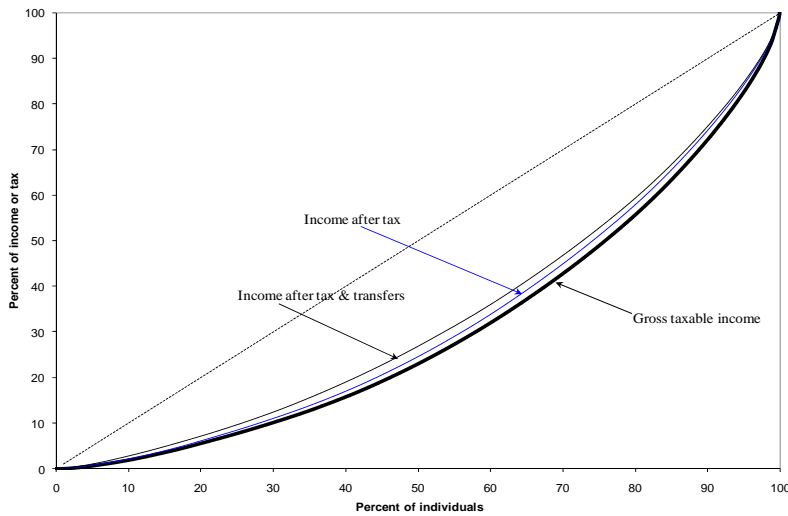
²² For a discussion of the advantages and disadvantages of a consumption tax versus an income tax, see Aaron et al (2007), Diamond and Zodrow (2008).

²³ Burman and Kravitz (2004).

²⁴ Variations on a consumption tax such as the flat tax or David Bradford's X-tax could protect low-income taxpayers from the burden of a consumption tax, but that simply means that more of the burden is placed on middle-income households, assuming revenues are to be maintained.

²⁵ Burman et al (2007).

Figure 1 The Distribution of Income in New Zealand, 2006-07



Source: New Zealand Treasury

The Figure shows that both the personal income tax system, and the system of social transfers – mainly family tax credits – have a redistributive effect towards greater equality (the post-tax and post-tax-and-transfer income profiles are closer to the 45° line, which represents pure equality, in Figure 1). Table 1 shows how the combination of the progressive income tax and transfer systems substantially mitigates economic inequality. Income tax liability for households in the lowest income decile averages 17%, rising to 31% in the highest decile. However, because the transfer system is heavily skewed towards those in the bottom 4 or 5 deciles, the lowest 4 household income deciles receive more in transfers than they pay in tax.

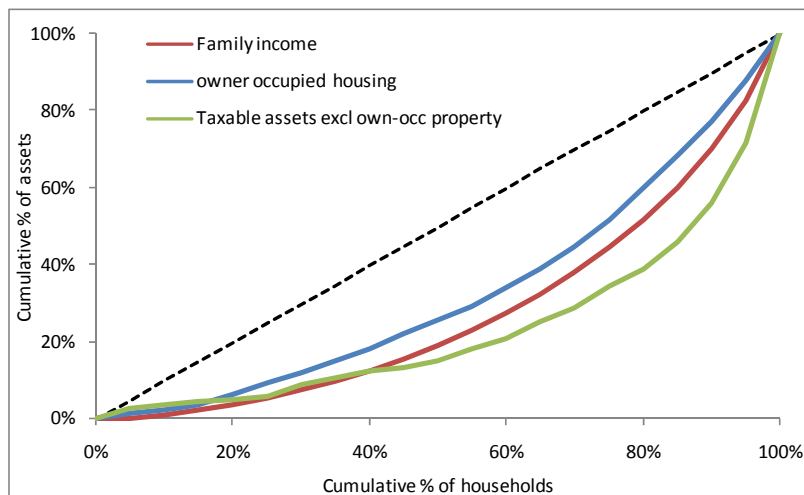
Table 1 Household Income Tax and Transfers as % of Taxable Income

Household Income Decile	1	2	3	4	5	6	7	8	9	10
Tax liability	17	17	18	19	20	21	23	23	25	31
Transfers	99	72	88	46	16	7	4	2	0	0
Taxes net of Transfers	-82	-54	-70	-27	4	14	18	22	25	31

Source: New Zealand Treasury (2009)

Since New Zealand does not, in general, currently tax capital gains, the “gross taxable income” profile in Figure 1 excludes most capital gain income. It would be interesting to compare this with the distribution of capital gain income to identify how far the taxation of capital gain income could alter the distribution of taxable income. Unfortunately these data are not available.

Figure 2 Distribution of Assets by Family Income Level



Source: NZ Treasury (2009), p. 21.

However, the distribution of assets across households in 2006-07 provides some clues. Figure 2 shows the distribution of family income by percentile, from lowest to highest, as recorded in the Statistics New Zealand Survey of Family, Income and Employment (SoFIE) data, and the comparable distribution of owner-occupied property assets, and all assets excluding owner-occupied property.²⁶ Excluding owner-occupied housing, assets are even more skewed than income. For example, the richest 10% of households owns 44% of non-housing investment assets. If capital gains are distributed in a similar fashion, taxing capital gains could bolster the overall progressivity of the New Zealand income tax.

4.2 Problems with realisation-based tax and concessional rates

The tax regimes for capital gains in most OECD countries, including Australia, follow neither the pure income nor consumption tax model. Typically, capital gains are taxed when realised, not as accrued, and losses are not deductible. Long-term gains held by individuals are generally taxed at a fraction of the rate of other income — typically more than they would be under a consumption tax and less than they would be under a pure income tax.

The rationale for such a system is that a realisation-based tax is the only practical option since some assets are hard to value and, even for those whose values are easy to assess annually, it would be unreasonable to require taxpayers to pay tax before they have disposed of the asset and realised the cash from sale. (We revisit these arguments in the next section.)

Conceding for a moment the necessity of taxing upon realisation, what is the argument for preferential taxation under an income tax? The ability to postpone paying tax

²⁶ We are grateful to the New Zealand Treasury for providing the data depicted in Figure 2.

for years or even decades is a valuable tax break by itself. (This is why corporate executives prefer to earn a large share of their compensation in deferred form, and why tax authorities generally try to limit deferral.) Why is a partial exclusion (as in Australia) or alternate lower tax rate schedule (as in the US) thought to be appropriate?

A number of arguments are made in favour of concessional taxation of capital gains:

1. The capital gains tax (CGT) discourages risk-taking and entrepreneurship
2. The CGT double-taxes savings
3. Capital gains are eroded by inflation
4. The CGT creates a “lock-in effect”
5. To the extent that it applies to shares of corporate stock, the CGT applies to income that has already been taxed at the company level.

We first address each of these issues in turn in the context of a realisation-based tax. In section 4.3.1, we suggest a better alternative taxation strategy that eliminates or reduces virtually all of these concerns while also reducing the opportunity for inefficient tax sheltering that is an inevitable by-product of the current taxation regime.

4.2.1 CGT and risk-taking

According to OECD (2006, p 91) “[o]ne reason behind Australia’s decision to preferentially treat capital gains (half inclusion rate) was recognition of the generally riskier nature of capital investment”. This argument seems to be at a minimum over-stated if not in fact wrong.

If capital gains were taxed upon accrual and losses were fully deductible against other income, taxing capital gains in full would be neutral with respect to risk. To see why, consider that the return on an asset in a competitive market (that is, one that is not expected to pay super-normal returns or pure economic profits) is comprised of three parts, the risk-free return, r , a risky part, e , and a return to risk-taking or risk premium, p . The after-tax return for the risk-free asset (say, short-term government bonds) is $r(1-\tau)$, where τ is the marginal income tax rate. The after-tax return on the risky (capital gains) asset is $(r+p+e)(1-\tau)$. The tax reduces both the risk (e) and the risk premium (p) proportionately. Since the marginal investor is indifferent between the risky and risk-free asset, the risk premium exactly offsets the additional risk, and the reduction in the risk premium caused by taxation is exactly offset by a reduction in risk. In other words, tax on the risk premium is effectively an actuarially fair insurance premium for the share of the risk that the government is taking on.²⁷ A taxpayer that was willing to hold both risky and riskless assets before imposition of the tax would also be willing to hold the same portfolio after imposing the tax.

²⁷ This analysis is developed in more detail in Burman and White (2003).

Of course, if capital gains assets paid an above-market return—say, $(r+p+e+\pi)$, where π is pure profit—the tax would reduce the return by $\tau\pi$ and make holders of such assets worse off. However, in that case the tax is still economically efficient and non-distortionary. Even after taxing away part of the pure economic profit and accounting for risk, the after-tax return would be higher than the risk-free asset by $\pi(1-\tau)$.

As long as losses are fully deductible, taxation of capital gains assets on a realisation basis lowers the effective tax rate on such investments as compared with a bond that pays a certain return r that is taxed currently on an accrual basis because the risky asset benefits from tax deferral. That is, even without a rate preference, risky capital gains assets are favoured over riskless assets. Moreover, more risky assets are favoured over less risky ones since they pay a higher average rate of return (have a higher risk premium) and the benefits of deferral are larger at higher pre-tax rates of return.

Of course, in realisation-based tax regimes, losses are typically only deductible against other gains. Auerbach et al (2000) found that, in the US, where losses in excess of \$3,000 must be carried over, most taxpayers were able to use their losses within one or two years. In the absence of capital gains taxation in New Zealand, there is no comparable evidence. It is, however, surely true that the loss limit is binding on some taxpayers who own only a single asset, such as a business. It is also likely that the current market meltdown will leave many investors with excess losses for many years.

It is not clear whether deferral alone is enough to compensate investors for the risk of taking a loss that they cannot fully deduct, or whether an additional preference is appropriate. The best option would be to change the taxation of capital gains so that losses could be deducted immediately against other income without risk of tax sheltering (by selectively realising losses and deferring gains). These issues are addressed in more detail below.

4.2.2 Double taxation of saving

As noted, under an income tax, saving is taxed twice. This entails a cost in terms of economic efficiency. Taxing capital gains is one form of taxing saving. However, because of deferral, capital gains assets face a *lower* effective tax rate than assets that pay returns in currently taxable forms such as interest, rents, and royalties.

If double taxation is a concern, the solution is to move to a consumption tax, in which all forms of capital income would be exempt from tax and interest expense would not be deductible. Moving one step towards a consumption tax, however, by exempting or lightly taxing capital gains is a recipe for inefficient arbitrage (tax shelters), as discussed below.

4.2.3 Inflation

In an unindexed tax system, inflation reduces the real after-tax return of all taxable assets. For example, suppose a bond pays 8% interest of which 4% represents a real return

and 4% represents inflation.²⁸ At a 25% tax rate, the after-tax nominal return is reduced to 6%, or a 2% real after-tax return. The 25% statutory tax rate becomes a 50% effective tax rate.

However, because the capital gains asset benefits from deferral, the real after-tax return increases over time.²⁹ In contrast, the real after-tax return on the interest-paying asset does not vary with holding period. Thus, again, the capital gains asset is less affected by inflation than other kinds of capital assets. The argument for indexation (to remove inflation from the calculation of capital income) applies with *less* force to the capital gains asset than to other kinds of assets.

Moreover, if capital gains are indexed for inflation or otherwise eligible for concessionary tax treatment, while interest expense is fully deductible, there will be opportunities for arbitrage. To take the simplest case, assume the same facts as in the example above and that an individual could borrow \$100 at an 8% nominal interest rate to purchase a capital gains asset expected to pay a 7% nominal return. Suppose for simplicity that the capital gains asset is held for only one year, just long enough to qualify for the 50% exclusion. The investment (loan and capital gains asset) generates a pre-tax loss, but an after-tax profit. The loan creates a deduction of \$8, but there is only \$3.50 in income (50% of \$7) attributed to the gain. At a 25% tax rate, the \$4.50 net loss generates \$1.125 in tax savings, more than offsetting the \$1 pre-tax loss. At a higher tax rate, the after-tax profit would be greater. Alternatively, if the gain had been indexed (with no exclusion) while the interest expense was deductible, the pre-tax loss would have been even greater (\$5 instead of \$4.50).

The law in most countries with a capital gains tax prevents such blatant efforts at tax arbitrage, but that simply stimulates the invention of more creative ways to generate current fully deductible losses offset by deferred and only partially taxed gains. Indexing the whole tax system for inflation would prevent this kind of inefficient tax arbitrage. Indexing one component, however, makes it worse.

4.2.4 The lock-in effect

Perhaps the most enduring argument in favour of lower tax rates on capital gains is that taxation upon realisation creates an inefficient lock-in effect — that is, the incentive to hold onto under-performing assets to avoid paying capital gains tax. It is a real concern (see, for example, Caygill (1989) and Bengé (1997)). For most taxpayers, the capital gains tax is voluntary. It can always be postponed. Thus, one would expect taxpayers' realisation behaviour to be very sensitive to capital gains tax rates. This is especially true in the US, where assets held until death escape CGT altogether. (As an alternative, assets transferred at death could carry over the cost basis of the decedent, so allowing gains to continue to be deferred, but it would not be forgiven altogether.)

²⁸ For simplicity, the example assumes that the real and inflation portion of the return are additive.

²⁹ Burman (1999).

In the United States, early research based on cross-sections of tax returns suggested that realisations were very sensitive to tax rates. Indeed, the elasticity of response was so high that the findings suggested that government revenues in the US would increase if the tax rate on capital gains were cut. Those findings, however, were in stark contrast to the results from time-series studies, which almost universally found that gains were not very sensitive to tax rates.³⁰

Burman and Randolph (1994) resolved this seeming inconsistency by showing that the time series studies were primarily measuring the long-run effect of changes in capital gains tax rates, whereas the cross-section studies primarily measured the sensitivity of the timing of capital gains to year-to-year variation in individual tax rates. Under a progressive tax system, as in the US, individual tax rates will vary over time because of changes in income and the use of deductions. Panel data showed that individual tax rates in the US varied a great deal from year to year. Individuals exploited this variation by delaying realisations when their rates were unusually high and accelerating realisations where their rates were below average.

The relevant measure for policy, however, is how individuals respond to permanently higher or lower tax rates. Burman and Randolph measured this effect by examining how realisations responded to variation in tax rates across states in the US, under the assumption that taxpayers could not easily exploit this source of variation. Burman and Randolph found that the permanent response—the parameter of interest for policy—was an order of magnitude smaller than the transitory (timing) response based on a panel of tax returns filed between 1979 and 1983, and the difference was highly statistically significant. What’s more, Burman and Randolph found that the very high elasticities measured in previous cross-section studies actually underestimated the timing response.

US investors’ responses to the delayed increase in tax rates on capital gains enacted in 1986 provides the clearest evidence of how sensitive timing is to year-to-year changes in capital gains tax rates. The *Tax Reform Act* of 1986 raised the top tax rate on capital gains from 20% in 1986 to 28% starting in 1987. Sales of shares in company stock in December of 1986 were 7 times their level in December of 1985.³¹ That timing response was consistent with the findings in Burman and Randolph (1994).

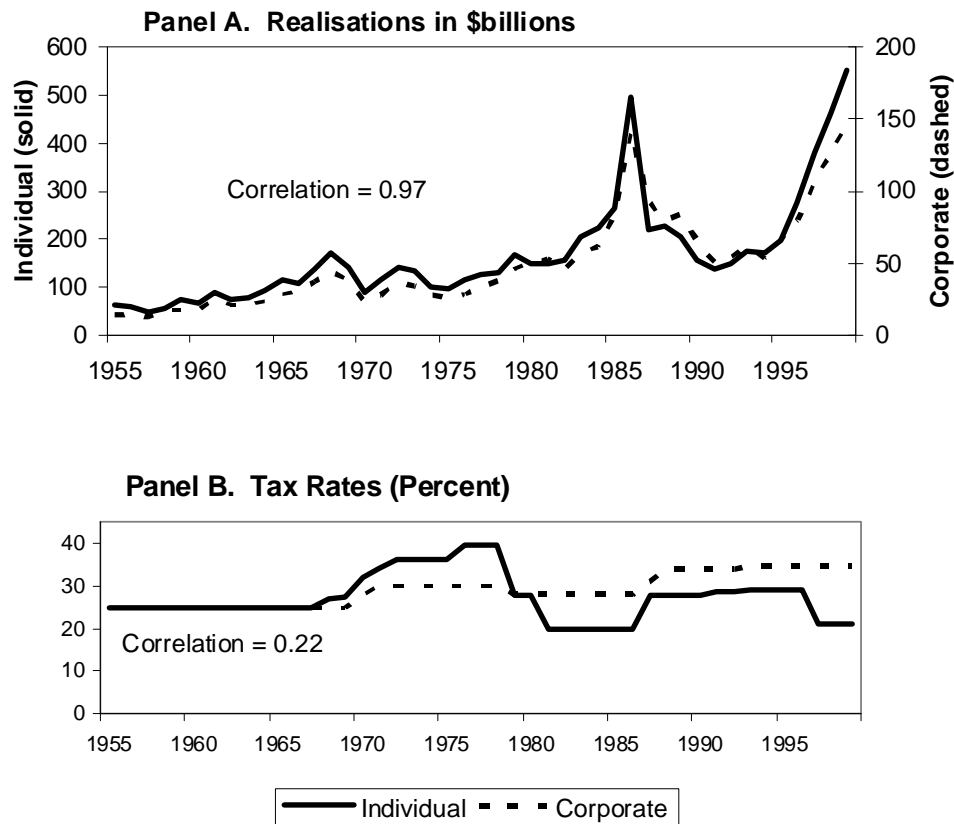
Of course, sophisticated investors can take advantage of year-to-year variation in tax rates to reduce their tax liability, and the advantages to doing so rise with the statutory tax rate. Auerbach and Siegel (2000) added expected future tax rates as explanatory variables and found that the long-run elasticity increased, although, surprisingly, by less for “sophisticated” investors than for others. The authors concluded that, rather than solving the riddle of capital gains, their results raise more questions about the true response of capital gains realisations to tax rates.

³⁰ Zodrow (1993) provides a very nice survey of the empirical evidence.

³¹ Burman et al (1994).

One final bit of evidence suggests that the lock-in effect may be less than one might expect. Burman and Plesko (2002) compared inflation-adjusted realisations of individual and corporate capital gains between 1955 and 1999 in the United States. If tax rates were an important factor in determining capital gains realisation levels, then one would expect the two lines to diverge because tax reforms tended to change the tax rates on individual and corporate gains at different times. In fact, individual and corporate capital gains track remarkably closely (see Figure 3). The correlation between the two time series is 0.97, suggesting that other factors—most notably the level of the US stock market—were much more important factors.³²

Figure 3. Real Individual and Corporate Capital Gains Realisations in the United States, 1955-1999 (in billions of 1999 US\$)



Source: Burman and Plesko (2002).

The realisations elasticity is a fairly gross measure of the effect of a realisation-based tax on behaviour. Poterba (1987) looked at the ability of taxpayers to shelter capital gains with losses and found some evidence, but much less than would be expected. The

³² One might think that the Tax Reform Act of 1986 was a large factor behind the high correlation, but the correlation is identical if the sample is limited to 1955-1985.

vast majority of taxpayers at every income level who sold capital assets reported a net gain based on data from the early 1980s. Auerbach et al (2000) looked at post TRA86 data and found similar results. High-income, high-wealth taxpayers were more likely to shelter their gains, but they represented only a tiny minority of those selling assets. Moreover, taxpayers had difficulty maintaining a net loss position. Most were realising sizable net taxable gains within a year or two.

On balance, the empirical evidence from the US suggests that lock-in is much less of a problem in practice than economists and tax practitioners would imagine. Moreover, lock-in is surely magnified in the US by the fact that capital gains taxes are forgiven on assets held until death. If New Zealand followed Australia's lead and required that capital gains carry over to heirs, lock-in would likely be even less acute because taxpayers could defer, but not totally avoid, tax by postponing gain.

4.2.5 Double taxation of corporate profits

In the classic income tax (as in the US), corporate profits are taxed once at the company level and again to the shareholder. This creates the possibility of double taxation of corporate profits because of the taxation of dividends and capital gains at the shareholder level. The potential for double tax has been used as the rationale for lower tax rates on both capital gains and dividends, as were enacted in 2003 in the US.

However, double taxation 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. Even to the extent that the company retains earnings, rather than distributing them, the credits partially offset the tax owed on capital gains. The earnings translate into higher asset prices, and thus more capital gains tax, but to the extent that profits are retained, the corporation also retains a valuable asset—the unused “imputation credits” which will shelter future distributions from tax. The credits should thus be capitalised into the value of the company, increasing the capital gain and partially offsetting the double tax.³³

4.3 Options for taxation of capital gains in New Zealand

Capital gains are income and should be subject to tax under an income tax regime. Failure to do so is inequitable, inefficient, and complicates tax administration.

The ideal capital gains tax regime, in theory, is to tax gains on an accrual basis.³⁴ Accrued losses would be fully deductible against other income. For companies, accrued gains would be treated identically to dividends (and would be eligible for imputation

³³ The offset is incomplete because the credits are retained without earning interest. Just as a deferred tax is less burdensome than a current tax, a deferred credit is less valuable than an immediate one.

³⁴ This proposal is very similar to one laid out by Halperin (1998) in his Woodworth lecture. Halperin was somewhat more guarded in his proposal, subtitled it “An Agenda for Research”, although he also says that “I do believe, however, that mark-to-market for traded securities is essential and promises enormous benefits” (p.502).

credits as dividends are now). This would eliminate the bias in the current system in favour of capital gains producing assets, eliminate a major vehicle for tax sheltering, make the tax system more equitable, and avoid the drawbacks of realisation-based taxation, including lock-in and the problems created by loss limitations.

In practice, there are significant problems in valuing illiquid assets such as family-owned businesses and real estate. Given transaction costs, accruals taxation for such assets is probably not desirable. Thus, we lay out two alternative options for taxing capital gains. In the first option, capital gains on easy to value assets would be taxed on accrual and gains on illiquid assets would be taxed using the risk-free return method (RFRM), as outlined by the McLeod Committee. While this option has the virtue of taxing a base equivalent to economic income, it would constitute a significant departure from practice in the rest of the world and may be difficult to build political support for. Both options would assess tax liability before income is realised—and the RFRM would impute income even when asset values had declined.

The second, more pragmatic, option is consistent with capital gains taxation in the rest of the OECD. Most gains would be taxed on realisation. Losses would only be allowed to offset capital gains, with net losses carried over to later tax years. Capital gains on owner-occupied housing held for a minimum period would only be taxable to the extent that they exceeded a threshold. In exchange for this concession, a small property tax would be levied on owner-occupied housing (so as not to create an artificial incentive to invest in housing).

4.3.1 Option 1. Accrual taxation (mark to market) for publicly traded shares and unit trusts and RFRM for illiquid assets

Accrual taxation solves virtually all of the problems with capital gains tax systems observed in practice, at least in theory. If gains and losses are taxed as accrued, there need be no limits on deductibility against other income. All publicly traded shares and unit trusts would be subject to the accrual regime. For a shareholder who holds shares for an entire tax year, the accrued income would equal the difference in price (adjusted for any stock splits) multiplied by the number of shares held plus any dividends distributed. For shareholders who buy or sell shares during the year, the gain or loss would be determined based on the actual time the shares were held during the year. Accrued income on unit trust shares would be calculated the same way.

For shares, imputation credits would be fully passed through to shareholders based only on their share of equity in the company and the portion of the year they held the shares. They would no longer be limited by (or even affected by) the share of profits that are distributed. Individual shareholders would simply claim the tax credits against their overall taxable income.

Since losses are fully deductible, this proposal eliminates any bias in the tax system against risk taking. There would be no lock-in effect since tax does not depend on whether the asset is held or sold. It would result in full integration of individual and corporate tax

(since credit imputation would not depend on distribution of profits). It would eliminate any realistic possibility of using corporate stock shares as a tax shelter.

Accrual taxation would substantially increase average tax revenues and improve the overall progressivity of the income tax. It would also significantly increase the volatility of tax revenues.³⁵ This is the corollary of the government's sharing fully in the risk of investments in capital assets. This is a gain for society to the extent that government is better able to pool risks—both across individuals and across generations—than individuals or businesses.³⁶

Moreover, this aspect of the proposal would produce a built-in stabiliser for macroeconomic policy. When the stock market collapses (as it has recently) taxpayers would accrue an enormous amount of capital losses which would slash their tax liability. When the economy and the market are booming, taxes would also increase, providing something of a brake on the economy.

The major drawback of accrual taxation is that it may create liquidity problems for shareholders who accrue substantial gains without realising cash from dividends or the sale of an asset.³⁷ One way to deal with this would be to allow shareholders to carryover their tax attributable to gains accrual with interest until the asset is sold (or sooner, at the shareholder's option). This approach is similar to a proposal made by Vickery³⁸ and Auerbach.³⁹

The ideal tax regime for assets such as real estate and closely-held businesses would be the risk-free return method, in which income is imputed based on the risk-free rate of return applied to the original purchase price of the asset. A version of this has been

³⁵ Burman and White (2003).

³⁶ The McLeod Committee (2001a & b) argued that the value of the extra tax collected on risky assets by virtue of their higher returns should not be treated as a gain to the Treasury since tax on the risk premium is exactly offset by higher societal risk. It would have no market value. Put differently, if the government has a greater ability to spread risk, it could capitalize on that by borrowing money at low rates and investing in a diversified portfolio of shares or other risky assets, at no cost to taxpayers. Of course, government acquisition of a substantial fraction of the share market would raise other concerns—not least being that government should not have financial control of private corporations except in unusual circumstances. Taxing capital gains is arguably a less costly way for the government to take advantage of its ability to spread risk over time. A more telling critique is that the government might manage volatile revenues poorly. It might be tempted to treat temporarily high revenues due to unusually high asset values as a permanent increase in revenues and increase spending, which might create a bias in favor of bigger government if eliminating new programmes is difficult when revenues decline. Even if government raises other taxes or cuts spending when capital gains are depressed and cuts taxes and boosts spending when gains are high, the additional risk assumed by government by taxing gains would be fully shifted back onto individuals and businesses. Risk pooling only works if government accumulates larger surpluses or smaller deficits when revenues are high and increases deficits or cuts surpluses when revenues are depressed.

³⁷ Halperin (1998, p.503) also expresses concern about "...problems caused by the existence of two separate regimes, in particular a mark-to-market system for publicly traded stock and a realization standard for closely held business". Unless legislation is carefully crafted, taxpayers might be able to switch between the two regimes to avoid tax.

³⁸ Vickrey (1939).

³⁹ Auerbach (1991).

in use in the Netherlands since 2001.⁴⁰ It was also proposed as an option by the McLeod Committee.

As noted above (section 4.2.1), assuming no pure profits, taxing the risk-free return, r , is economically equivalent from the asset holder's point of view to taxing the accrued return, although unlike in the accrual case the taxpayer bears all of the investment risk rather than sharing some with the government.

The main drawback in the RFRM is political: it is hard to imagine telling asset holders whose real estate values had plummeted (as they have recently in parts of the US) that income was being imputed at a 3% rate based on the elevated purchase price.⁴¹ Even though the taxation is fair and efficient, *ex ante*, it would be difficult to sustain it *ex post*. (The Dutch manage to do it, perhaps because their rate of tax is low).

A possible concern in this proposal is that investors may view the RFRM as more generous than accruals taxation, even though it is economically equivalent for the typical asset and the typical investor. Investors may expect their investments to earn pure economic profits, which would be untaxed under the RFRM. Some may also be less averse to risk than average, in which case, they would strictly prefer RFRM, which exempts both the market risk premium and the associated uncertain returns from tax. This might reduce demand for listed shares and unit trusts and encourage some companies to delist. Furthermore, in the absence of aligned top marginal and company income tax rates, using RFRM to tax unlisted companies might enable labour income to be sheltered in companies (as it is under the current regime).

One option to address these problems would be to tax shares and unit trusts at a lower rate than RFRM assets. Another option might be to allow imputation credits only against capital gains taxed under the accrual method. A third solution might be to tax all assets under the same regime, as discussed below.

4.3.2 Option 2. Realisation-based tax

The second-best alternative would be to tax all assets on a realisation basis under the income tax. Losses would only be allowed against gains. Net losses could be carried over to future years. Gains or losses should be assessed and taxed at time of death to prevent unlimited deferral of gains. To prevent taxes from forcing the dissolution of family-owned businesses, gains on business and farm assets could be carried over at death, although that does exacerbate the lock-in problem. Émigrés would either have to pay capital gains tax on accumulated gains or post a bond guaranteeing future payment at the time a realisation event occurs. To avoid double-taxation, credits could be allowed against foreign capital gains taxes paid by émigrés.⁴²

⁴⁰ Cnossen and Bovenberg (2000).

⁴¹ Burman and White (2003).

⁴² See section 4.3.2.5 for a discussion of these rules in the Canadian context.

Most countries provide preferential treatment for capital gains on owner-occupied housing. Although a preference creates a bias in favour of owner-occupied housing, full taxation creates efficiency costs because it can prevent families from moving to more appropriate housing when their circumstances change, such as when children leave home.⁴³ However, an unlimited exemption for owner-occupied housing can create an incentive to amass house estates as a tax shelter, as apparently has become a problem in Australia.⁴⁴ The solution is to allow a generous, but limited, exemption for capital gains on home sales (as is done in the US). To qualify, the homeowner should have lived in the home as primary residence for a minimum number of years (three out of the last five in the US). This is to prevent investors from buying homes, living in them briefly while renovating them, and then earning a tax-free gain on the home sale.

An exemption for capital gains on home sales would favour investment in housing over other, possibly more productive, assets. Given that over-investment in housing is already a concern in New Zealand, this could be undesirable.⁴⁵ The playing field could be levelled by assessing an annual property tax on home values at a rate that would raise roughly the revenue forgone by the home exemption.⁴⁶

4.3.2.1 Is a realisation-based tax worth adopting despite its flaws?

Some commentators have argued that taxing capital gains on accrual would be a significant gain for efficiency and equity, but it is impractical because of valuation problems and, furthermore, that it would be undesirable for New Zealand to adopt a taxation regime that is not used anywhere else in the world. Taxation based on realisation is the norm in the rest of the OECD. By current standards, New Zealand's current approach of exempting most capital gains from tax is almost as much of an outlier as would be accruals taxation, so if conformity is the goal, a realisation-based tax is the solution.

A realisation-based tax as outlined above would be far from perfect, but the comparison must not be to an unattainable theoretical ideal, but to the deeply flawed system currently in place in New Zealand. The current system is inequitable, inefficient, and creates large challenges for tax administration and compliance. We would argue that a realisation-based tax regime would be an improvement against all of the criteria for good tax policy.

4.3.2.2 Efficiency of switching to a realisation-based tax

Imposing a capital gains tax would reduce one type of distortion—favouring capital gains assets over other forms of investment—while creating new distortions with respect to

⁴³ See Hui Shan (2008) and Burman *et al* (1997) for a discussion of economic evidence of taxing capital gains on home sales in the US.

⁴⁴ Dobbin (2009) recounts stories of wealthy Australians hoarding real estate as a tax shelter.

⁴⁵ Coleman (2009) shows in a simple model, however, that capital gains taxation could exacerbate the effect of credit constraints on home ownership. Although the conclusion arises from a very stylized model, it could provide a rationale for concessional treatment of housing relative to other assets.

⁴⁶ See Coleman and Grimes (2009) for a discussion of the economic effects of land and property taxes.

the timing of sale of assets. Whether the new tax improves efficiency depends, in part, on the importance of the lock-in effect versus the inter-asset distortions and incentives for tax sheltering that exist under the current system. There is not rock-solid empirical proof that one option dominates, but the available empirical evidence discussed above suggests that concerns over lock-in have been overstated, especially if capital gains are taxed at death.

There are other efficiency aspects of the proposal. Favouring owner-occupied housing over other assets could be a problem, but it is addressed with a small annual property tax. Moreover, it should be noted that the current tax regime already includes an incentive to over-invest in housing, since housing gains are completely exempt from tax. This makes housing a more advantageous investment than interest-bearing assets, which are fully taxed.

As noted, the current system creates a strong incentive to invest in inefficient, unproductive tax shelters. Taxation of all gains at the same rate as other income would significantly reduce the opportunities for arbitrage. The only tax advantage of capital assets would arise from the deferral of tax, which could be significant should high rates of inflation return. If inflation remains modest, the advantage of deferral would be at least partially offset by the limitation on deductibility of losses.

Moreover, the capital gains tax raises revenue that can be used to reduce income tax rates, which enhances economic efficiency. In addition, since the capital gains tax primarily falls on those with high incomes, it could make possible relatively more reliance on the GST, which disproportionately hits lower-income families. Since consumption-based taxes avoid double-taxing saving, the switch from income to consumption tax increases efficiency, and is desirable if the equity concerns can be addressed.

If lock-in is judged to be a serious problem, it can be reduced by taxing capital gains at lower rates than other income (for example, by including only part of capital gains in the tax base). The right level of taxation would balance the efficiency and equity gains from taxing gains against the efficiency losses from lock-in.

It is highly unlikely, however, that the optimal balance is reached at a capital gains tax rate of zero. And, most other OECD countries have judged the right rate to be positive. Further, a usually well-informed journalist has speculated that the final report of the Henry Review of the Australian tax and transfer system may recommend removal of the 50% discount on capital gains, in part to finance a reduction of the Australian company tax rate to between 25 and 30%.⁴⁷ Finally, the capital gains tax is more difficult to administer with lower rates of tax on gains than other income, providing a stronger case for something close to full taxation.

⁴⁷ Martin (2009).

4.3.2.3 Equity of switching to a realisation-based tax

Taxing capital gains clearly improves vertical equity, since high income people earn most capital gains. It is also a boost for horizontal equity overall, since capital gains assets would not be untaxed while other forms of income are taxed, although some inequities would remain under a realisation-based tax. As noted above, assets that produce losses can be disadvantaged under such a tax, although experience in the United States suggests that most losses can be claimed against other capital gains within a few years.

Another issue is that capital gains assets can be lumpy. A small business owner might realise a large gain in one year and never realise any other gains. Under a progressive income tax, this could push her into a higher tax bracket. One solution is to adopt the Australian approach, allowing such taxpayers to calculate the average tax rate on gain based on one-fifth of the total capital gain. This can improve equity, albeit at the cost of some complexity for the taxpayer.

4.3.2.4 Administrability of a realisation-based tax

Concerns have been raised about the administrability of a capital gains tax based on realisation. The tax would be relatively challenging to administer, but again the question is compared to what? The current tax system creates significant challenges for tax administration, as discussed in section 2. A good deal of effort is spent on policing the boundary between revenue and capital. If capital gains are fully taxed, that boundary is largely irrelevant since it does not change the tax consequences (with the exception of losses, where the distinction can be relevant). If gains are taxed at lower rates, the boundary would still matter, but there would be less incentive for taxpayers to artificially classify transactions as capital, which would improve voluntary compliance.

A capital gains tax is not simple to comply with, although it is not particularly difficult for listed shares and unit trusts. If compliance burdens are a significant concern, then small capital gains could be exempted from income tax (and the disregard could be allowed for other purposes, such as determining eligibility for means-tested transfer programmes).

For taxpayers with substantial investment income, the current regime is arguably more complex than the new one because the boundary between capital and revenue is so idiosyncratic. A rational and consistent definition of capital gain could be easier for taxpayers to comprehend and comply with.

On balance, we judge a capital gains tax as a plus for tax administration because it would strengthen the integrity of the income tax, reduce the incentive for tax sheltering and evasion, and rationalize the definition of income for tax purposes. Moreover, most other OECD countries successfully administer a capital gains tax, so New Zealand clearly can as well.

4.3.2.5 Transition Issues⁴⁸

If New Zealand decides to include capital gains more broadly in the tax base, it will have to decide how to manage the transition. The issues are especially important when capital gains are taxed upon realisation. Since accrual taxation and RFRM would each depend only on current asset prices, it is comparatively straightforward to include future gains in income under those regimes.

Canada and Australia took different approaches to phasing in capital gains taxation. Canada introduced a realisation-based capital gains tax in 1972. Australia introduced one in 1985. Canada decided to tax future gains on existing assets after a set date, which they called the valuation date, or V-date. Australia decided to exempt from tax assets that had been purchased before the effective date for their legislation.⁴⁹

Australia's approach has some obvious advantages. People did not have to try to establish the cost basis for an asset that had been held for decades and for which records might be scant or nonexistent. They did not have to assess the value of assets already in portfolio, but only newly purchased one. The Australian approach, however, also had some serious disadvantages. Most notably, it created a horrendous lock-in effect. Assets held in 1985 were to be tax exempt, whereas a newly purchased asset would be taxable on any future gain. Assuming an effective capital gains tax rate of 20% (the 49% top tax rate on ordinary income reduced by the value of indexing for inflation and deferral), an asset in a portfolio would be held even if it were expected to pay a 20% lower rate of return than alternative investments. Put another way, the gain on pre-1985 assets, which were exempt from capital gains tax as long as they are held, were worth 25% more if held than they would be to a new purchaser in the same tax bracket.

Canada avoided this problem by requiring that tax be paid on gains accruing after the V-date, regardless of when they were purchased.⁵⁰ Strictly applied, this rule would have seemed inequitable to taxpayers holding assets with losses as of the V-date, who might nonetheless have had to pay tax on that part of any gain that was really just a recovery of a previous loss.

To get around this problem, Canada allowed taxpayers to elect an alternative method for establishing tax cost to be applied to all assets purchased before V-date. Under the alternative method, assets with losses as of the V-date would be exempt from tax on any gain until the price reached its original cost. The area between the base cost (that is, the purchase price plus the cost of any improvements) and the V-date price was referred to as the neutral zone. Price movements inside that zone produced neither gain nor loss. If the asset price continued to fall, a loss could be claimed relative to the V-date price. This is illustrated in Box 1.

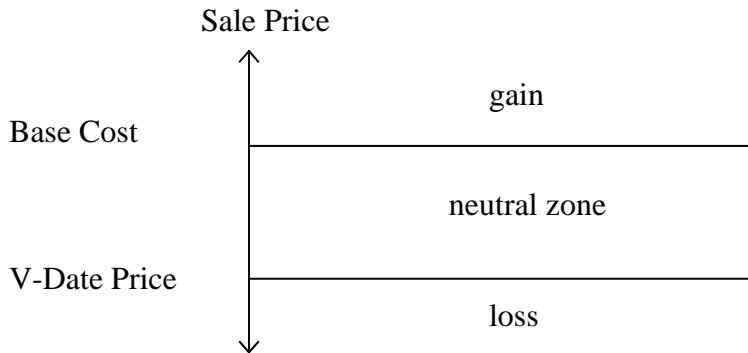
⁴⁸ This section largely reproduces section 4.3 in White and Burman (2003).

⁴⁹ Australia also decided to index gains for inflation, a decision that led to considerable complexity and was ultimately reversed. Broadly, indexation for inflation has been frozen at 30 September 1999 for assets acquired prior to 21 September 1999 and held for more than 12 months.

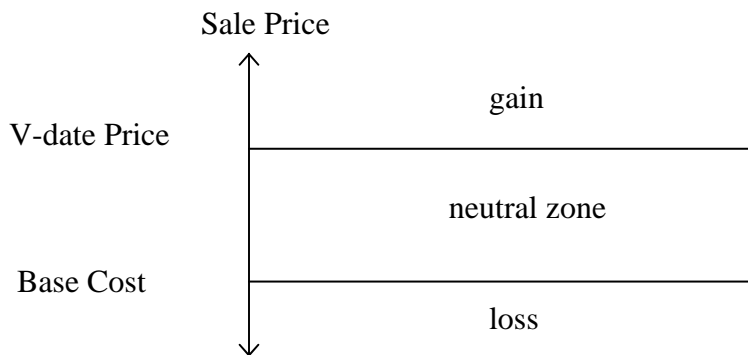
⁵⁰ We are very grateful to Bob Brown for providing a detailed oral history of Canada's transition and the logic behind it.

Box 1.
Determination of Gain Under
Alternative Valuation Method in Canada

Case 1: V-Date Price < Base Cost



Case 2: V-Date Price > Base Cost



A symmetric rule had to be applied to assets with gains. Assets that had increased in price as of the V-date would be disallowed losses if the sale price were in the neutral zone (i.e., between V-date price and base cost). If the asset price increased from the V-date, gain would be calculated relative to the V-date base cost. Declines in the asset below the purchase price could be claimed as a loss.⁵¹

⁵¹ This complex set of rules can be summarised by a simple mnemonic. Rank the base cost, V-date price, and sale price from lowest to highest. For purposes of calculating either gain or loss, the middle number is treated as the base cost.

These rules were designed to be taxpayer-friendly without allowing taxpayers to cherry pick—i.e., pick the most favourable rule for each separate transaction. Taxpayers who wished to use the alternative valuation method had to elect it when they first sold a pre-1972 asset after the V-date. The election applied to all future sales of such assets and was irrevocable.

The V-date was December 31, 1971, for assets other than publicly traded securities. Tax authorities, however, were concerned that a pre-announced V-date for securities might cause prices to be distorted, either because of deliberate manipulation or because of an unusual level of market activity arising from tax planning transactions. Thus, Canada picked the V-date for publicly traded securities at random after the end of the 1971. The actual date selected was December 22, 1971. To help establish value for real estate, brokers were commissioned to create a set of guidelines for valuation, which varied by locality, area, and type of use. Tax authorities not only collected valuable data by this means, but also won some support for the new regime from an important interest group. They also published information booklets and worked with tax practitioners to make sure that they understood the new rules. The theory was that people with the largest gains would be enlisting the advice of tax professionals, so this was an efficient way to educate the affected public.

Not too surprisingly, there were many disputes between the government and taxpayers regarding valuation of companies, especially in the years immediately following the introduction of the capital gains tax. Most of the disagreements were over the valuation of private companies and real estate.

Special transition rules and practices applied to old assets. Although taxpayers were required to report a sale in timely fashion, they were often allowed extra time to calculate the gain or loss and pay tax (subject to interest charges on any late payments). In certain cases, auditors applied weaker substantiation requirements for assets purchased before the V-date, requiring only that a good faith effort be made to establish an accurate value.

Although the Canadian tax is far from pure, it contains some key anti-avoidance provisions that the United States model lacks. Notably, capital gains are generally taxed at death. Transfers to a spouse or child are tax-free, but the recipient of the gift acquires the tax basis of the asset. Moreover, if the asset is sold during the lifetime of the transferor, the gain may be attributed back to the transferor and taxed as if it had not changed hands. Other gifts are generally treated as realisation events.

Émigrés are deemed to have disposed of their capital assets when they leave the country. They may defer payment of the tax, but only if they post a bond. The initial provision contained loopholes that have since been closed and the provision remains controversial. Taxpayers complain that the tax can lead to double taxation if gain is ultimately taxed by the foreign jurisdiction, and the deemed realisation can create cash flow problems for assets that are not sold. Canada has attempted to deal with the issues

of double taxation by modifying tax treaties and creating a retroactive foreign tax credit in cases where a person can show that the gain was ultimately taxed by another country.

4.3.3 Discussion

A key virtue of these proposals is that they would sharply curtail the incentive for individuals to invest in tax shelters. Most individual income tax shelters are driven by the differential between the tax rates on capital gains and ordinary income. With a 38% top income tax rate and a 0% capital gains rate, a tax shelter that could transform \$1 million of ordinary income into capital gain is worth up to \$380,000 to create. That is why geniuses who might otherwise do productive work have been drawn to financial engineering or into fields that can earn income in the form of capital gains rather than income. With such huge tax incentives, the investments that produce capital gains do not even have to be particularly productive. Thus, many resources invested in such underperforming assets may be wasted.

Eliminating that waste would be good for productivity. It would also bolster support for the income tax. A tax system riddled with loopholes, where billionaires can pay lower average tax rates than their secretaries, invites disrespect and undermines voluntary compliance.⁵²

A major concern about taxing capital gains at rates up to 38% (and which rise further in an inflationary environment) is that it may discourage saving and investment. Although the concern is likely overstated, if policymakers are worried about that, the right solution is not selective preferences for capital gains assets, but lowering tax rates overall. The best option would be a tax reform that broadened the base, eliminated loopholes and preferences, and cut top rates across the board. A second-best option might be a Scandinavian style dual income tax, in which wages are taxed at a higher rate than all capital income; see Sorensen (2005). However, as Sorensen (2009) notes, New Zealand's very high rate of international labour mobility may make a Scandinavian style dual income tax system less viable here. A simpler option might be to pay for income tax rate cuts with higher GST or payroll tax rates and offset the burden on lower-income families by increasing the low-income family allowance.

⁵² American billionaire, Warren Buffett, chairman of Berkshire Hathaway and one of the richest men in the world, has complained that he should not be taxed at a lower rate than his secretary; see Tse, (2007). Buffet's income comes almost entirely from lightly-taxed capital gains while his secretary's arises from wages, which are subject to both income and payroll taxes.

Appendix. Composition of Household Assets

Table A1 shows the composition of household assets. These have been aggregated into “all assets” and “taxable assets” - those that might most readily be subject to capital gains taxation (with or without including owner-occupied housing). It can be seen that owner-occupied housing represents over 50% of those assets.⁵³ Excluding owner-occupied housing, the main taxable assets classes are business assets (55%), investment property (32%) and financial assets (mainly shares: 14%).

Table A1. Composition of Household Assets, 2004⁵⁴

Asset Type	Value (\$ million)	Percentage Distribution		
		All Assets	Taxable (including housing)	Taxable (excluding housing)
Owner-occupied housing	264,889	42	56	
Investment property	67,076	11	14	32
Financial assets in unit trust/funds	12,591	2	3	6
Financial assets NOT in unit trust/funds	15,807	3	3	8
Business ownership & investment	115,059	18	24	55
Motor vehicles	18,678	3		
Sporting & leisure equipment	6,074	1		
Household items	77,299	12		
Bank account assets	28,538	5		
Life insurance	13,908	2		
Miscellaneous (e.g. art, cash not in bank)	3,686	1		
Total	623,605	100		
Total Taxable Assets	475,421		100	
Total Taxable Assets (excluding housing)	210,533			100

Source: Statistics New Zealand Survey of Family, Income and Employment (SoFIE)

⁵³ We exclude the following assets from the “taxable” category: motor vehicles, sporting/leisure equipment, household items, bank accounts, life insurance assets, and miscellaneous assets.

⁵⁴ The “household” is defined in the SoFIE data as the “Economic Family Unit” and consists of non-partnered individuals or couples with or without dependent children. We are grateful to the New Zealand Treasury for providing the data depicted in Table A1.

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