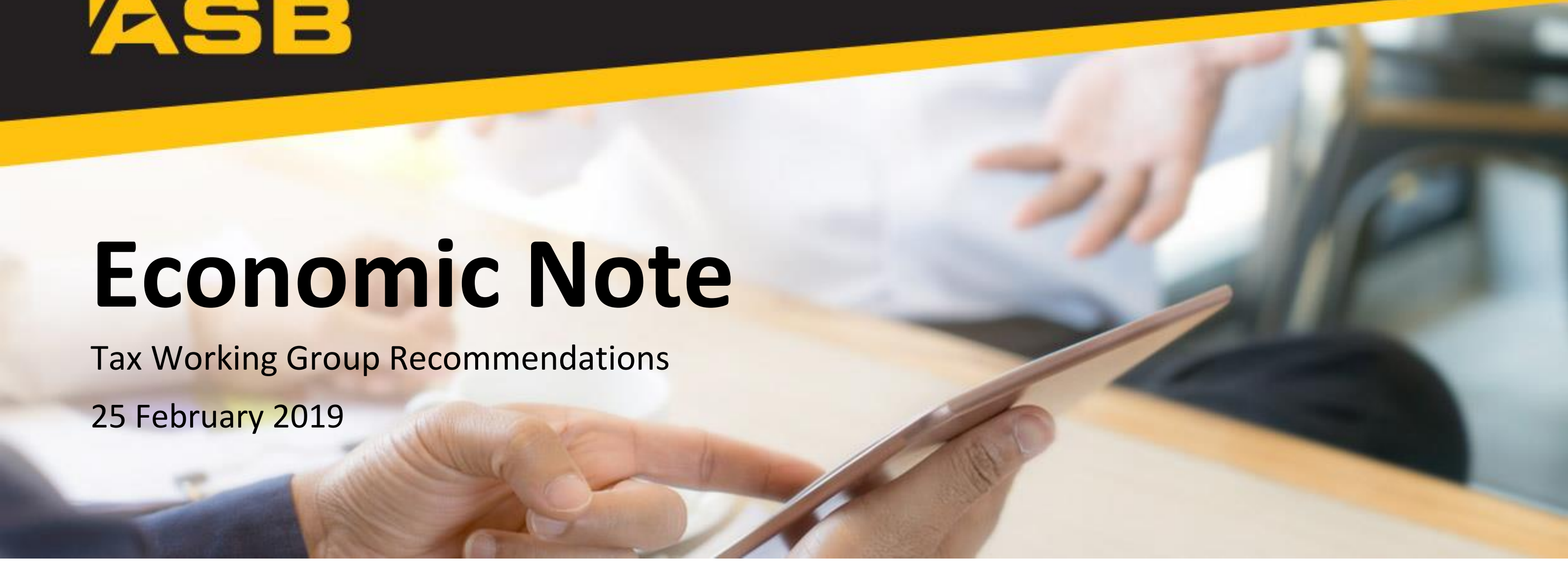

Economic Note

Tax Working Group Recommendations

25 February 2019

Non-technical summary and our key take-outs

Last week the Tax Working Group (TWG) released its final report, which proposed a significant reworking of the current tax system. The report was well signalled, with tax changes due to take place in 2021, and does not appear to provide any major surprises. However, the devil lies in the detail. The report is thorough and it will take time for markets, policymakers and investors to get to grips with the key details and implications.

The TWG recommendations are only that and are not binding to government, which has the option to accept only some (or none) of the report recommendations. The changes will need to be put into legislative form and approved by Parliament to go into law, and we expect some watering down of the TWG recommendations (for example, the treatment of farm assets under the new regime is an area where the views of the coalition partners differ). Nevertheless, the TWG report represents a shot over the bow of property investors and other households and businesses that have been beneficiaries from current gaps in the NZ taxation system.

The TWG made a number of recommendations. Taxation is seen to be a tool that could support environmental objectives and promote the transition to more environmental sustainability. The biggest news, however, was proposals to extend the taxation of capital income. New Zealand is an anomaly compared to OECD peers, with light tax treatment on capital returns as opposed to income. The TWG proposes that a realisation-based tax is applied to capital gains at the time of sale on a broad range of assets. The tax would not be retrospective (a "Valuation Day" of 1 April 2021 when the tax is implemented is signalled) and the tax rate will be set at the income-earner's marginal tax rate, which will be up to 33% for higher wage and salary income earners.

There would be a few exemptions, most importantly the family home (including a family home on farms), art, boats, cars, bikes, jewellery, and personal household items. Moreover, capital gains tax on small businesses (including farms) can be deferred (using "rollover" relief) if annual turnover is less than $5 million and sale proceeds are reinvested in similar asset class. However, investment properties and holiday homes will be included in the capital gains tax system.

The package is designed to be revenue neutral. There are sizeable distributional implications. To meet the Government's objectives of improving incomes of low- to middle-income earners, the new tax system will be increasingly progressive. The estimated $8.3bn obtained from the CGT over the first five years will be offset by modest tax cuts for lower income earners. Corporate taxes will not be cut.

The proposed changes could generate quite sizeable impacts. While the changes are not signalled to come in until 2021, it is possible that assets that are potentially susceptible to the CGT will adjust (downwards) as the likelihood of the imposition of a CGT increases. This may already be happening.

Moves to broaden the NZ tax base and look into the taxation of capital helps to level the playing field, but the

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proposed measures may also impose costs, create distortions and facilitate unintended consequences and these could hamper economic efficiency. The CGT may also dissuade productive investment and risk-taking if it significantly lowers after tax returns. Assets may be hoarded or "locked in" to prevent paying a CGT. There could also be some sizeable transition costs as firms and households adapt to the new regulations. There are also intergeneration implications if the TWG recommendations are enacted. We note that the economy is at the mature phase of the expansion and asset prices have already done their dash. Hence the initial pickings from a Capital Gains Tax (CGT) are likely to be slim.

There are implications for the residential property market. Owner-occupier dwellings will be exempt from a CGT, but the changes will likely dampen investor demand for residential rental property and exert downward pressure on house prices. We note that a number of policy measures have already been introduced to slow investor demand so it will be difficult to discern the impact of the proposed CGT on the housing market. There are claims that the changes could potentially trigger rent increases and reduce the supply of rental accommodation. However, the evidence regarding this is mixed at best and the TWG has proposed some tweaks in tax treatment that could reduce the tax burden on investors. We will be closely scrutinising residential property market listings and wider data for clues.

Introduction

On 21 February the Tax Working Group (TWG) released its long awaited report on proposed changes to the NZ Tax system. The proposed changes, if enacted represent a *significant reworking of the current tax system.* The full report can be accessed here. The TWG report provides recommendations that are not legally binding. Legislation will need to be drafted and approved by Parliament to become law. The Government is not obliged to accept any of the recommendations of this report. Indeed, the Government may pick and choose what it sees as the best parts of the Group's recommendations. There are also significant differences of opinions between the Government coalition partners to be resolved. The Government is set make an announcement over the next few months, likely in April.

Estimated timeline	
21 February 2019	TWG report released to public. *Majority of TWG recommend a capital gains tax.*
Through April 2019	Coalition partners negotiate and agree on what parts of TWG report to adopt as Government policy. *Sticking point may be NZ First's opposition to CGT on farmland.*
April 2019	Government announcement on its intentions regarding the TWG recommendations. *The Government could adopt some or all of the recommendations, or its own modifications.*
Mid-2019	Public consultation
Late 2019	Draft law introduced to Parliament
Mid 2020	Law Passed. *Government aims to pass legislation before Election 2020, to take effect in 2021*
By 21 Nov. 2020	General Election - *21 November 2020 is the latest it can be held.*
1 April 2021	Tax changes commence - *only if the Labour Government (and agreeable coalition partners) are re-elected. Any new government can repeal or modify the current government's tax changes (as observed in 2017).*

Source: ASB

The report focused mostly on proposing changes to the tax system

In a nutshell, the TWG found that while the current tax system has strengths (it is simple and cheap to administer), it is heavily reliant on a relatively narrow range of taxes (mostly income- and consumption-based) and is not particularly progressive. It is also out of step with taxation systems in other OECD economies. A number of key areas were outlined:

Capital gains

The TWG proposes to extend the taxation of capital income. New Zealand is an anomaly compared to OECD peers, with light tax treatment on capital returns as opposed to income. As such there are strong grounds for the broad extension on capital income on equity, efficiency and integrity grounds.

The majority of TWG members supported the introduction of a broad approach to the taxation of capital gains. **They**

propose a realisation-based capital gains tax (CGT) that applies to capital gains on a broad range of assets, with capital gains taxed within the current tax system and taxed at the marginal income tax rate of the asset holder (up to 33% for higher wage and salary income earners), with no allowance for inflation.

The CGT is realisation based and is levied at the time of sale. It would only captures gains and losses that arise after the implementation date of any new laws (i.e. Valuation Day, 1 April 2021). The TWG also specified that taxpayers should have five years from Valuation Day (or to the time of sale if that is earlier) to determine a value for their included assets as at Valuation Day.

The tax will be comprehensive including land and improvements, business assets, shares and intangible property. Farms would also be liable, although the family home on the farm and surrounding land up to 4,500m^2 would be exempt. The family home and personal use assets – e.g. art, cars, boats, and household durables will be exempt. Existing rules should continue for overseas shares.

Housing and Property Market rules

While the TWG did not propose taxation changes for the family home, **owners of second homes (including holiday homes) and investment property owners will still be liable**. Indeed, the report noted there was "a clear case to include residential rental investment properties".

To free up the provision of residential land, the Group also backed a Productivity Commission recommendation that local governments consider a tax on vacant residential land. Moreover, the Group considers that any residential vacant land taxes would be best levied as local taxes rather than a national tax. The group also recommends that the 'ten-year rule' which taxes a gain when the property has increased in value due to changes in land use regulation be repealed, so as to incentivise land to be sold more quickly rather than land-banking for ten years to avoid this tax.

The TWG reports also discussed the risk that landlords will pass on the impact of a capital gains tax to rents. Overseas evidence is mixed. To mitigate this risk, the TWG suggests Government consider removing ring-fencing tax losses on residential rental properties as well as reinstating the ability for landlords to claim depreciation as a business expense.

Environmental taxes

The Group saw significant scope for the tax system to sustain and enhance New Zealand's natural capital. Taxation is seen to be a tool that could support environmental objectives. The TWG notes that "immediate priorities should be to expand the coverage and rate of the Waste Disposal Levy, strengthen the Emissions Trading Scheme and advance the use of congestion charging". Moreover, in the medium term, environmental tax revenue should be used to help fund a transition to a more sustainable economy.

The recommended changes were in recognition of the adverse externalities and wider economic costs that environmental degradation and congestion produce. Users should pay for more of the costs. The changes may steer users towards alternatives that could be more beneficial for the public good. **We note that for these charges to be optimal, feasible alternatives will need to be in place.** For congestion charging, the provision of efficient public transport or ride-sharing schemes would significantly meet objectives and prevent the scheme become a tax grab.

Taxation of business, including farms

The TWG note the current approach to the taxation of business is "largely sound" and does not see a case to reduce the company rate "at the present time or to move away from the imputation system". It did not propose an alternative basis of taxation for smaller businesses, such as cash flow or turnover taxes. However, the NZ Government should monitor company tax rates of OECD peers (e.g. Australia). **The group proposes some tweaks that could improve productivity and boost business investment,** including expanding deductions, increasing concessions for significant infrastructure projects and restoring depreciation allowances if a capital gains tax is extended. The TWG also proposed that capital gains tax on small businesses (including farms) could be deferred if annual turnover is less than $5 million and sale proceeds are reinvested in similar asset class.

The rural sector clearly has a lot of interest in the changing rules – the significant capital investment that farmers have in their land and improvements could soon be taxed. Indeed, the TWG noted that the agriculture, forestry and fishing industries have had the highest untaxed gains out of all industry groups. A capital gains tax will change incentives around farm ownership, investment/divestment, and transfers – the changes also have the potential to change the preferred farm business model. We also note that while the proposed taxes to be paid at the sector level are relatively small, the lumpy nature of the tax will mean a smaller number of farmers would bear the tax load in any given year.

The TWG has proposed some concessions to farm businesses and small businesses more generally. That is, capital gains tax can be deferred (using "rollover" relief) if a (farm) business's annual turnover is less than $5 million and sale proceeds are reinvested in similar asset class. The level of concessions to the sector (if not the outright exclusion) will be a particular point of contention in the Government's discussions with NZ First. With this in mind, we wouldn't be surprised to see further concessions incorporated into the Government's announcements come April.

Taxation of savings

The TWG did not see a case to reform radically the taxation of retirement savings. **However, to promote increased saving from lower-income earners, it supported several changes to KiwiSaver.** Recommendations include refunding the employer's superannuation contribution tax for members earning under $48K, increasing the Member Tax Credit, and reducing the lower "PIE" tax rates (10.5% and 17.5%) by 5% each. There was also a case to make returns from the circa $40bn New Zealand Superannuation Fund exempt from New Zealand tax obligations. Both will have fiscal policy implications. Capital gains from investing in domestic shares would now be subject to taxation on realisation when held directly, and by accrual within a managed fund, while current rules for investment in foreign shares would continue.

Personal income taxation

To meet the Government's objectives of improving incomes of low- to middle-income earners, the TWG proposes to increase the progressivity of the personal tax system. The Group's preferred approach is to increase the bottom income tax threshold. This could potentially be combined with an increase in the second marginal tax rate, resulting in a much lower increase in after-tax payments for those on upper incomes. It was also recommended that the Government consider increasing net benefit payments to ensure beneficiaries receive the same post-tax increase as other people on the same income. **Bracket creep is likely to continue.** It was notable that the TWG did not recommend that tax rates were indexed for inflation nor that the inflation component of interest income was exempt.

Proposed personal income tax changes – Options 1a and 1b (proposed changes in red)

Current Bottom Tax Bracket	Option 1a	Option 1b	Tax rate (%)
0-$14,000	0-$22,500	0-$20,000	10.5

Proposed personal income tax changes – Option 2 (proposed changes in red)

Current Bottom & Middle Tax Brackets	Current Tax Rates (%)	Option 2 Tax Brackets	Option 2 Tax rates (%)
0-$14,000	10.5	0-$30,000	10.5
$14,001-$48,000	17.5	$30,001-$48,000	21

Source: ASB

Maintaining the integrity of the tax system

As the TWG note, the "integrity of the tax system requires constant vigilance". **To address tax avoidance, maintain a wide tax base, and maintain integrity of the tax system, the TWG supported extending the taxation of capital gains as well as efforts of the IRD to increase the compliance of the self-employed**, and to expand and extend the use of withholding taxes to increase compliance.

Some areas requiring further work were outlined, including:

- **A potential shake-up for tax exemptions for charities and private charitable foundations and trusts** – tax exemptions of charitable businesses "confer an unfair advantage to the trading operations on charities" and the current rules "appear to be unusually loose".
- **No changes to GST.** The TWG has decided not to recommend a reduction in the GST rate or the introduction of new GST exceptions. Moreover, the TWG does not recommend introducing a financial transactions tax at this point.
- **The development of a framework for deciding when to apply corrective taxes.** The TWG recommends that the Government review the rate structure of alcohol excise with the intention of simplifying it. In addition, the group recommends the Government prioritise other measures to help people stop smoking before considering further increases in the tobacco taxes (beyond those currently scheduled). The group also recommends the Government clarifies its goals regarding sugar consumption and gambling activity.

Economic Impacts – our take outs

The aim of the changes was to bolster the equity, efficiency and integrity of the tax system, which should be positive for economy-wide welfare. It may also boost the economy over the longer term *if* it tilts more investment towards productive capital away from less productive uses. Given NZ's poor productivity track record this would be welcome.

The proposed changes bring NZ more into line with OECD peers, although taxing capital gains at the marginal income tax rate of the asset holder does seem high. One consequence could be the shifting of asset holdings from family members with high to low marginal tax rates.

The biggest uncertainty from a wide CGT is whether or not it does trigger a boost in NZ's productive capital stock. The relative price signal to shift away from residential property investment (widely viewed as an inefficient use of capital) to other assets is not being materially altered, other than for notable exceptions such as the family home. **But a key blight on NZ's productivity performance (and income levels) is a lack of capital stock. Taxing productive assets, such as privately- and publicly-held businesses, farms, and commercial property is in itself hardly an incentive to increase investment in them**, relative to consuming in the here and now. Crucially, NZ is a country of small businesses. To what extent will small business owners step back from investing in "sweat equity" to expand their businesses if they would face a sizable proportion of these rewards being taxed in the future? And arguably, the taxation of overseas investment is relatively favourable under the proposals.

Whether the economy is indeed left better off will depend a lot on the extent to which the tax changes would boost the capital stock and shift investment into more productive assets. Significantly, the behavioural incentives away from investment property would be stronger if it was the sole asset being taxed – and the risk of discouraging productive investment in general would be eliminated. A CGT solely on residential investment may, therefore, be more effective in driving more efficient capital allocation. But it would leave less fiscal scope to focus on the other part of 'fairness', including income tax cuts and KiwiSaver incentives specifically targeted at low-income earners.

If enacted, the changes could help slightly improve housing affordability, but they are unlikely to be a silver bullet and will only have a modest impact. Countries with capital gains taxes still have unaffordable housing. Moreover, overseas evidence suggests that other changes in the market are likely to swamp any effects from tax changes. And when it comes to NZ housing, addressing the root cause of why such large property capital gains have been able to persist is where the solution ultimately lies.

The tax recommendations are designed to be revenue neutral, but initial pickings from the CGT are likely to be modest. The taxation of capital gains is projected to raise around $8.3bn over the next five years, equivalent to around 1.2% of our nationwide GDP. The reason for this is that the signalled changes are not retrospective and that previous windfall gains remain exempt. We note, however, that the economy is at the mature phase of the expansion and asset prices have already done their dash. The property capital gains horse has well and truly bolted in Auckland and may be nearing the final straight in other parts of the country.

While the changes are not signalled to come in until 2021, it is possible that assets that are potentially susceptible to the CGT will adjust (downwards) in value as the likelihood of the imposition of a CGT increases. This may already be happening even though the imposition of a CGT is some way off. Even though owner-occupier residential dwellings are exempt from a CGT, the tax impact on dampening investor demand and the prices that investors are willing to pay will likely place further downward pressure on residential property values.

The changes would have potentially sizeable transitional impacts as firms and households adapt to the new frameworks. A length transition period is allowed for to provide households and businesses with time to adjust to the new systems and to get asset valuations done. It may not be enough if the impacts are more sizeable than envisaged.

There will also be significant distributional impacts. The proposed changes are designed to bolster lower-income earners. Whilst higher-income earners will not face income tax increases, their after-tax returns on investment sales will be lower. There are also intergenerational aspects given that asset holdings tend to increase with age.

There will be unintended consequences. There is the risk that firms and households will focus on trying to exploit loopholes and minimise their tax burden rather than focus on their core business. **Assets may be hoarded to avoid paying the tax on sale.** What exactly constitutes the family home and the ownership structure of second homes are murky areas. Accountants and valuers will be busy if the new regime is implemented!

Sub-optimal lock-in behaviours are a potential problem arising from a realisation-based capital gains tax. "Lock-in" is a situation where an investor is unwilling or even unable to sell an asset because of the tax liability that occurs when the asset is sold. The problem with "lock-in" is it leads to the investor retaining ownership of an asset, even if they would prefer to sell it (if not for the tax liability). It also denies another owner the chance to invest and make better use of the asset. **On a more positive note, lock-in may encourage some investors to take a longer-term perspective, but it also could deter others from investing.** The TWG acknowledges that the exact impacts are difficult to quantify. Furthermore, the extent of lock-in would be influenced by the specifics of any "rollover" treatment (rollover treatment provides a deferral from taxation in certain situations, particularly for small businesses, including farms).

There would be administrative costs to get the system up and running and compliance costs will also be higher. The TWG report acknowledges this but notes "these costs would be outweighed by reductions in investment biases, as well as improvements to the fairness, integrity and fiscal sustainability of the tax system". The TWG notes the trade-offs and highlights potentially greater complexity regarding the treatment of corporate groups, unlisted shares and business goodwill.

Impacts on the residential property market

All the members of the Group agree that there should be an extension of the taxation of capital gains from residential rental investment properties. **Our view is that the changes are expected to put downward pressure on residential property prices and improve housing affordability.** Owner-occupier dwellings will be exempt, **but the changes will likely dampen investor demand for residential rental property.** The TWG acknowledges that while the tax system was not the primary cause of unaffordable housing in New Zealand, it has likely exacerbated the cycle. In the view of the TWG, the proposed changes are likely to support housing affordability, and further tilt the balance in favour of owner-occupier purchases rather than property investors.

In other words, house prices are likely to be lower given the impact they will have on investor demand and the expected future after-tax returns for some property investors. Depending on the impact of investor demand, this could have a significant impact on property values. However, the TWG has been careful to offer a carrot to investors in the form of removing ring-fencing tax losses on residential rental properties.

There is the risk that residential landlords increase rents to offset the hit to their after-tax returns upon the point of sale. However, the TWG notes there is little empirical evidence to suggest rents have increased as a result of the introduction of a capital gains tax in countries such as Australia and Canada. We will have to wait and see and will be closely monitoring dwelling rents for tell-tale signs.

Making it more expensive to land bank via increasing local authority rates should theoretically help boost dwelling supply and improve housing affordability. However, capacity constraints and the extensive infrastructure requirements in developing land will mean that even if more land became available it would take considerable time to translate into an increase in the dwelling stock.

We note that there have already been a number of policy measures, including those to limit investor leverage, restrict overseas investment, reduce non-professional investor demand and reduce expectations for future outsized capital gains, that have already been put in pace to tilt the playing field more in favour of owner-occupiers. Other regulatory measures which dampened investor demand include preventing the ability to offset losses on rental properties against other incomes sources and the Healthy Home Bill.

There will also likely be some temporary volatility in the housing market ahead of the capital gains tax introduction. We can expect investor demand to be weaker than it otherwise would have been. This is another headwind facing the residential property market and some vendors may rush to sell properties before the law change. We will be closely watching property listings for tell-tale signs. Any surge in house listings (without a corresponding increase in demand) is likely to drive a temporary fall in house prices. Auckland listings have been steadily climbing to around historical averages, whilst listings in other areas of the country have been very low. Note there is also potential for similar volatility in the farm-land market.

Has the property market already adjusted to the new regime? This is difficult to know in advance. While we do expect new investor demand will be weaker as a result, the market may already have adjusted for much of the impact. **Will some regions be more impacted by the proposed changes?** The Auckland housing market is likely to be more sensitive to a fall in investor demand as it currently has the highest share of investor buyers than the rest of the country (38% of new lending vs 33% nationwide). It is possible that the recent cooling off in the Auckland residential market may be attributable to other recent and pending policy changes and stretched affordability rather than in anticipation of a CGT.

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