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A NEW TREATMENT FOR HOUSES UNDER A CAPITAL GAINS TAX

PETER NORTH
02102492121
24 RAME ROAD GREENHITHE, AUCKLAND 0632

INTRODUCTION

This submission proposes an alternative treatment for real estate under a capital gains tax ("CGT") system. Consequently, it is clearly contingent on a capital gains tax being implemented and legislators deeming it necessary to offer special treatment to households. Though proper attention may be devoted to these two issues in a future detailed submission, they are dealt with in brief below:

1. A capital gains tax is inevitable: Equality motivations aside, with the treasury predicting substantial funding deficits post 2020 if the current status quo is preserved, raising or inventing additional taxes is unavoidable.[1]
2. Preferential treatment is necessary: Voters are extremely adverse to any imminent threat to their finances. Though home ownership is decreasing, if future legislators carry ambitions for an enduring CGT, one that is not endangered with immediate repeal by the next government, allowances will be necessary to comfort a population comprised of many who believe that home ownership should be a state-guaranteed path to prosperity. This fact is clearly accepted overseas and was by the Labour party in 2014 as well.

THE TREATMENT OF HOMES ABROAD

Despite lacking a single uniform approach, with marginal deviations caused by administrative differences, foreign strategies to deal with real estate generally fall within two categories. Subject to varying restrictions, the principle private residence of a taxpayer is absolutely exempt in Australia, Canada, Ireland and the United Kingdom. In contrast, only a large fixed amount of property gains are tax free in both South Africa and the United States.[2]

THE INADEQUACY OF EXISTING SYSTEMS

Contrary to the main ambitions of a CGT, to equitably tax all income as far as practicable and to generate additional tax revenue, substantial exemptions (irrespective of whether they are absolute or fixed) still facilitate large untaxed profits to be generated by investment activity on the property market.[3] With absolute exclusions, taxpayers are incentivized to avoid CGT completely by investing exclusively in their homes when real estate prices are increasing (which they normally are). This practice, occasionally labelled as 'mansioning,' occurs because the gains made on other investments without preferential treatment will be subject to much higher taxation. This is a serious problem in Australia where overly generous tax incentives have contributed to a very large property bubble.

[1] New Zealand Treasury *Affording Our Future – Statement of New Zealand's Long-term Fiscal Position,* (11 July 2013) at 3.
[2] Chris Evans and Cedric Sandford "Capital Gains Tax – The Unprincipled Tax?" [1999] BTR 387 at 395.
[3] See slide presentation.

Alternatively, large fixed exemptions can be inequitable because they are not often contingent on time.[4] Across all surveyed nations, only the United States imposed material time restrictions (this is covered briefly on page 3.) When exemptions are not absolute, the optimal strategy is to realise them as often as possible – thus benefiting prosperous taxpayers who have capital mobility and own expensive property which appreciates faster.

CREDIT APPROACH

After rejecting those aforementioned methods, a unique approach is suggested. Simply, the arrangement would work by assigning taxpayers with yearly instalments of accumulating "household tax credits" (credits) that are available for use until death. When liable to tax on a household capital gain, a taxpayer may reduce their tax bill by applying their credits to it. Hence, the system is best summarised as one which makes available tax relief contingent on time, the longer a taxpayer waits to sell residential property, the more exemption they are entitled to.

CREDIT AMOUNT

In the subsequent submission, the amount of credit that all taxpayers receive will be considered. This author notes that there are several possible benchmarks, each with its own trade-off between tax effectiveness and political palatability. Evidently, the faster taxpayers can accumulate substantial credit amounts, the less comparative advantage this system has over its counterparts.

It was originally envisioned that credits would only accrete at the bare minimum rate that is needed to shield home owners from paying tax on gains solely caused by nationwide inflation. Hypothesising credits at $3500 per year is a good illustration of this intent. At this level, homeowners situated in our top tax bracket would be insulated a 33% tax on inflation gains (historically about 2% per year) for an average priced home ($518,000), but no more.[5]

Though political acceptance will necessitate increasing these instalments, setting the credit level at this rate (or similarly lower rates) would provide two distinct advantages:

1. By limiting tax concessions, the Inland Revenue Department would collect more tax revenue than otherwise. This may also assist the tax system to become more progressive by enabling the reduction of other income taxes such as PAYE.
2. Market efficiency will be encouraged. Because the yearly tax allowance is proportionately small, particularly for expensive houses, the majority of large gains will be subject to the same

[5] The Real Estate Institute of New Zealand "REINZ Statistics" (10 January 2015) <https://www.reinz.co.nz/reinz/public/reinz-statistics/reinz-statistics_home.cfm>

rate of tax that most other investments are. Without this tax distortion, taxpayers with disposable fortunes may consider investing in more productive assets, such as into shares or unlisted companies. This is preferable as most investments benefit the economy far more than real estate inflation does.

SPECIFICS

The following sub-parts demonstrate the technical aspects of the system irrespective of credit rate.

DISTRIBUTION OF CREDITS

Credits will only benefit natural persons residing in New Zealand, thus excluding absentee landlords or businesses. Therefore, yearly credits would only accrue to New Zealand residents or a citizens that have been present in the country for more than 183 days cumulatively in the tax year. Unless gains made prior to enactment will also be taxable, there are no need for initial bumper credits to protect homeowners against inflation in previous years. Through working for families, New Zealand already experience in administering a tax credits system.

CREDIT SHARING AMONGST COUPLES

Taxes should be relationship neutral, favouring neither legal couples nor single persons. However, this is not necessarily the case in systems abroad. For example, families in the United Kingdom are generally restricted to one exempted household between them, thereby incentivising homeowners to remain unmarried if their partners own a house as well.[6]

Under this system, couples in a recognised relationship[7] can choose to consolidate their credits for use on a single gain, or to use them on different properties as desired. This author accepts that some safeguards, possibly a stand down period for new marriages, may be necessary to prevent abuse by artificial relationships, such as those arranged purely to combine credits.

NO RESTRICTIONS ON RESIDENTIAL PROPERTY

Systems with large or absolute exemptions require tight regulation over qualifying property. For example, taxpayers in the United States are required to have owned their property for five years and have used it as their principle residence for at least two of those five years before disposal.[8] Alternatively, Canadian law restricts family units from having more than one principle residence in any

[6] Taxation of Chargeable Gains Act 1992 (UK), s 222-226.
[7] Married Couples, Civil Unions and De Facto Relationships as defined by Property Relationship Act, s 2.
[8] Internal Revenue Code 26 USC §121.

tax year. In these countries, because entitlement effectively attaches to the property itself, a taxpayer's access to those exemptions is only restricted by their ability to nominate properties as a primary residence. Without these rules, taxpayers could essentially cheat the system, using exemptions only intended for homes on their investment properties as well.

In this proposal, those considerations are less important. From a practical perspective, it makes no difference whether a taxpayer utilizes credits on their primary residence, a holiday home, or on an investment property because it will reduce the amount of credits they can use on subsequent disposals. As the national available exemption should be low and capped, the system can afford taxpayers the luxury of assigning credits to the disposal of as much real estate as is necessary to consume them.

NO RESTRICTIONS ON MIXED USE PROPERTY

Whilst the credits are primarily intended household disposals, this author recognises that some real estate is mixed use, such as farms or stores with attached dwellings. This is an important issue for full exemption systems which, unless managed, would allow the tax free disposal of predominantly business assets. Consequently, such jurisdictions are burdened with cost of apportioning mixed use properties between business and personal uses. Again, this system simplifies matters, and will allow the use of credits on any real estate with a recognised dwelling.

Ironically, taxpayers trying to exploit this leniency would inadvertently benefit the economy because it would require them to own productive assets. Furthermore, balance is preserved as taxpayers spending credits on mixed use disposals would have less credits to use for their disposal of traditional households.

THE USE OF TRUSTS

When considering whether properties held in trust should benefit from CGT exemptions, legislators are torn between two competing priorities: recognizing that trusts often have a legitimate role in the organisation of some taxpayer's affairs; and preventing the use of trusts as a mechanism to circumvent taxes. The contrast between South Africa and Canada is representative of this conflict. In South Africa, all property held in trust, with the exception of special disability trusts, are excluded from claiming CGT deductions.[9] Alternatively, provided that a trust designates the same property as its beneficiaries, it is possible for personal trusts in Canada to claim its principle residence exemption.[10]

[9] Income Tax Act 1962 (South Africa). Eighth Schedule, Part VII, ss 44-45.
[10] Canada Revenue Agency "Income Tax Folio: S1-F3-C2" (4 August 2014) <http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s1/f3/s1-f3-c2-eng.html>.

As recently demonstrated during the election debates, this contentious issue is of great relevance to New Zealand because of our disproportionately high number of trusts.[11] Notably, whilst the Labour Party favoured South Africa's approach, this would have left taxpayers facing large compliance costs to transfer their properties out of trust. Those same properties would then have become vulnerable if originally put into a trust for asset protection.

Recognizing these factors, this author prefers an inclusive approach, one that does not force taxpayers to compromise between tax or trust benefits. On the disposal of property held in a family trust, an individual or two trustees in a recognised relationship will be permitted to use their own personal credits to reduce the trust's tax liability. This eliminates any inconsistencies in the treatment of houses inside or outside of trusts, allowing some trustee pairings (most likely settlor and spouse) to use their personal credits as if it was a sale on property in their own names.

GIFTING AND INHERITANCE

The author has assumed that whilst gifting would constitute a disposal, tax liability would be rolled over on death. It is conceded that adjustments will be necessary should the general structure of a CGT deviate from this.

Credit usage should be governed in a way which achieves parity between all three forms of disposal: sale, gifting and inheritance. To these ends, as gifting is treated as a disposal, it would be treated exactly the same as a sale under this system.

The issue of inheritance is more complex but can be governed in the following manner: in the event that a deceased testator had unused credits, those credits should be divided evenly amongst any surviving property that would have enjoyed the use of credits. Once divided, the tax credits would be converted into actual value and then added to the initial acquisition value of the property, an addition which would decrease taxable profits on the eventual sale.

The actual value of credits is the amount of gain they would effectively make tax free. This is calculated by dividing the available credits by the deceased's average marginal tax rate (or a flat rate if this existed). For example, if a deceased taxpayer had 10,000 credits and a tax rate of 20%, the real value of those credits is $50,000.

If a settlor's remaining credits did not advantage their heirs, testators would be motivated to pre-emptively gift or sell their property immediately before death and then settle the proceeds. This is because the after-tax revenue from that sale would be larger with the use of credits than if the property

[11] In 2013, the Law Commission estimated that there are between 300,000 and 500,000 trusts in New Zealand: Law Commission *Review of the Law of Trusts: A Trusts Act for New Zealand* (NZLC R130, 2013) at 6.

was sold immediately after death. Adjusting property values is preferred to transferring credits because it ensures that a testator's credits will never be utilized on property that they never personally owned.

Word Count: 1950 excluding footnotes

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