POLICY POINT

THE PITFALLS OF CGT

Dr Patrick Carvalho

Tax Working Group's proposed rate of capital gains tax one of the most penal in the world

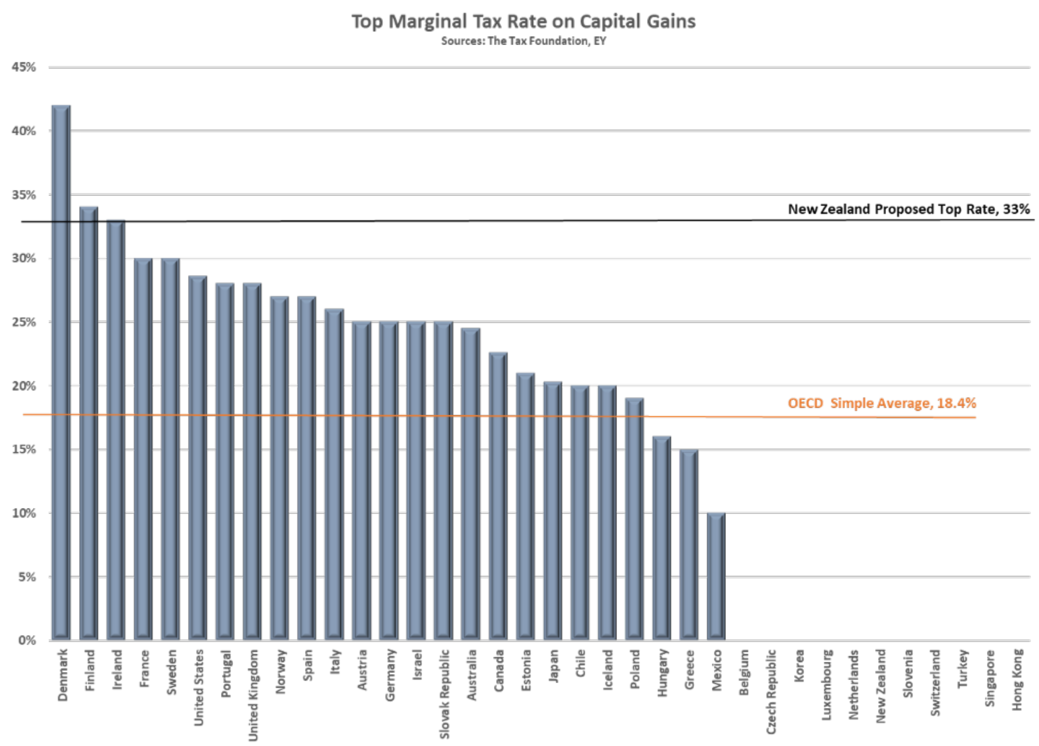
The Tax Working Group's report released today proposes a broad-based top rate of 33% capital gains tax.

That headline rate would immediately push New Zealand to the top of the international CGT rankings among industrialised economies, just behind Denmark and Finland (chart below).

The proposal is conspicuous by a lack of exemptions and concessions around business investment, so a full rate would arguably qualify New Zealand's CGT regime as one of the harshest in the world.

Worse, given New Zealand's recognisably low income tax thresholds by international standards, a new CGT would disproportionally hit middle-income earners already struggling to invest for retirement.

New Zealand should be cautious about siren calls for a top-ranking CGT. Trying to punch above our weight can sometimes place us in the wrong fight category.



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Pandora's Box

Despite high hopes for reaping more revenues for the Crown and promises to tax the wealthy, CGT implementation might not be as straightforward, fair or money-spinning as originally expected.

As a general rule, tax systems are a moving puzzle with interconnected pieces. Changing one part here affects another part elsewhere, usually in unpredicted ways.

Hence, the design and implementation of a new CGT regime in New Zealand require serious considerations and many judgment calls – with no clear-cut answers.

Despite the report recommendations, ultimately the government bill will have to address whether:

- Should current assets be grandfathered (as was in Australia)?
- Should capital gains be taxed after adjusting for inflation?
- Should capital losses be offset against ordinary income? If so, should they be ring-fenced (i.e. deferred to future capital gains offset)?
- Which assets should be exempt and under which conditions?
- What would be the impact on investments – and on labour productivity (i.e. wages)?
- What would be the effect on capital markets? Should foreigners' capital gains in New Zealand be taxed?
- Would compliance costs be manageable?
- Would CGT be calculated on accrual or realisation basis?
- Would lock-in effects significantly damper economic efficiency?
- What are the spill over effects on other tax collections?

For the everyday taxpayer, these questions have real implications. Each produces a set of winners and losers – and surely a windfall for lawyers and accountants.

To illustrate, say a million-dollar investment property appreciates below the line of inflation and sells for $1.1 million a few years later. Under an inflation-adjusted regime, no capital gains are due; under the current TWG proposal, a tax bill should be paid based on the $100,000 nominal return, even with prices falling in real terms.

Similarly, consider a middle-income family with $200,000 to invest. Should the investment money go towards a new rental property subject to CGT or towards a larger family home? Under the primary residency exemption, the latter might seem more advantageous purely because of CGT regulations rather than other more productive - options.

Bear in mind these are fairly simple examples. Real-life situations are often messier and uncertain, with harder trade-offs at stake.

At the New Zealand Initiative, we remain cautious about the net benefits of introducing an extensive CGT regime – particularly at the current proposed form. A broad-based 33% top rate is certainly too high and out of line with international practice.

New Zealand should not underestimate the complexities of introducing an extensive CGT regime. As the saying goes, for every complex problem there is an answer that is clear, simple…and wrong.