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The relationship between principles and policy in tax administration: Lessons from the United Kingdom capital gains tax regime with particular reference to a proposal for a capital gains tax for New Zealand

Simon James[1] and Andrew Maples[2]

Abstract

It is unusual to find a tax in operation which does not represent a compromise between tax principles, policy and administrative considerations. However, the third of these, tax administration, often does not receive the attention it should as proposals for tax reform are developed. This paper examines one particular case, the possibility that attempts to introduce a capital gains tax (CGT) in New Zealand (NZ) have been unsuccessful because the right balance between the three dimensions of tax reform has not been achieved and that for this and other possible reforms each of these aspects should be given the appropriate consideration. New Zealand does not currently have a comprehensive CGT. In fact, political commentators have long said that the enactment of a CGT in NZ would be 'political suicide'. The reasons for such antipathy towards a CGT are not entirely clear especially given the successful implementation and operation of CGT in many jurisdictions, including the United Kingdom (UK). However, sentiment towards a CGT in NZ appears to have softened more recently. Perhaps sensing this rise in support, the centre-left New Zealand Labour Party in the 2011 and 2014 general elections unsuccessfully campaigned on, inter alia, introducing a comprehensive CGT. It is unclear what part the CGT proposal played in its defeat in both elections with other factors in play. However, noting that the CGT policy may have alienated voters in the 2014 election, Labour Party leader, Mr Andrew Little has indicated that reform of the NZ tax system, including a possible CGT, would not be made 'without going to the people first and getting a mandate to do so'.3 Accordingly, the electorate support for a CGT, and its design (including the administration of the tax), will be crucial for its political viability in NZ; hence the rationale for this paper. The paper finds that the UK CGT is a very robust tax but has never taken a pure form based only on the principles of good tax design. Indeed its success in tax policy terms has been largely accounted for by pragmatic modifications over the years to accommodate the different and changing political and economic pressures applying to modern tax systems. The paper concludes that a more pragmatic approach could lead to the design of a CGT that may gain the broad support of the NZ electorate and also be as enduring as it has been in the UK.

Keywords: capital gains tax, tax administration, tax policy, tax principles, sustainability, tax compliance

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1. I

However, the country is unusual among Organisation for Economic Development and Cooperation (OECD) countries as it does not have a comprehensive capital gains tax (CGT).[19] Rather, certain specified capital gains are taxed in the Income Tax Act 2007 (NZ). Despite various committees considering the implementation of a CGT in NZ, admittedly with differing conclusions,[20] and overseas bodies such as the OECD[21] noting the benefits of a CGT for the NZ economy, there has been a longstanding antipathy against adopting the tax. While more recently sentiment may have softened among some business leaders and politicians,[22] more will be required in order for any

support of a CGT in NZ (such as equity[25] and efficiency)[26] have been well canvassed as have the flaws in the current income tax system in the absence of such a tax.[27] While some review committees have supported the implementation of a CGT in NZ,[28] it has been a long held belief that the enactment of a comprehensive CGT in NZ would be '[a] sure-fire path to political suicide'.[29] Former Prime Minister, the Rt Hon David Lange reputedly characterised 'a capital gains tax policy as one likely to lose you not merely the next election, but the next three.'[30] Interestingly, the closest NZ has ever come to comprehensively taxing capital gains was under the reformist fourth Labour government, which was led by Lange until 1989.[31]

The strength of feeling against a CGT is curious to those outside NZ, including one of the authors of this paper, given that CGTs have been implemented around the world, including the UK and, more recently, South Africa (in 2001). On the bases of its widespread adoption and relative longevity as a tax, CGT has been successful. One of the reasons for such success is that CGT scores well in terms of the principles of

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[25] See, for example, Alvin Cheng, Howard Davey and Keith Hooper, 'The Perceptions of Tax Teachers on Taxing Capital Gains in New Zealand' (2010) 16 New Zealand Journal of Taxation Law and Policy 217, 233.

[26] For a discussion of the principles in support of a CGT, see Rick Krever and Neil Brooks, A Capital Gains Tax for New Zealand (Victoria University Press for Institute of Policy Studies, Wellington, 1990); Paul Kenny, 'Capital Gains Taxation for New Zealand: Fairer and More Efficient' (2001) 7 New Zealand Journal of Taxation Law and Policy 265; Leonard Burman and David White, 'Taxing Capital Gains in New Zealand' (2003) 9 New Zealand Journal of Taxation Law and Policy 355; Leonard E Burman and David I White, '

equity and efficiency. An understanding of the antipathy toward the tax in NZ, and whether Labour's proposals contain the right balance between policy, principles and administration, may aid in the development of a CGT policy in NZ.

In fact, at first sight, one of the difficulties with the various committee reports considering the introduction of a CGT in NZ as well as Labour's recent proposals is that administrative issues have been insufficiently addressed and as a consequence seen as insurmountable.[32] Huang and Elliffe posit that:

> The reason historically that New Zealand does not have a CGT is not because New Zealand policymakers fail to recognise the benefits of such a form of taxation, but because they have been overawed by the perceived problems and cost associated with it. In looking at the history of this tax

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New Zealand's experience with another new form of taxation—the goods and services tax—has been very positive[39] partly because it did not face serious administrative concerns. The emphasis of the policy design of the GST strongly focussed on simplicity with equity concerns being dealt with outside the GST itself (via the welfare transfer system).[40] As a consequence the GST is economically very efficient. This positive experience with a comparatively 'pure' tax, with its few exemptions,

centre-left parties, it is probable that Labour will drive the policy design of any future CGT. The 2011 and 2014 policy statements are currently the best indication of the shape of such a tax at this point and no doubt will inform the development of any future policy. It is clear from a reading of the policy statements that they are the product of much research and analysis (even though essentially produced as part of Labour's election manifesto). Second, and related to the first point, of the politicamhou(x a)9.ec.N

> forward to a point which many did not believe was possible six months ago. This new tax will provide a background of equity and fair play for his work.
>
> Moreover, there is no doubt that the present immunity from tax of capital gains has given a powerful incentive to the skilful manipulator of which he has taken full advantage to avoid tax by various devices which turn what is really taxable income into tax-free capital gains. We shall only make headway against avoidance of this sort when capital gains are also taxed. [61]

So, in theory at least, the economic principles of efficiency and equity suggest there is a straightforward case for treating all capital gains as income but there is also the third criterion mentioned above of administrative considerations. Needless to say, there would be practical difficulties in taxing capital gains in precisely the same way as other income. The first and most obvious difficulty concerns capital gains which arise only through increases in the price level. Such nominal gains do not, of course, increase an individual's real spending power and should not in principle be counted as income.

A second problem is that, in theory, CGT should be levied on an accruals basis. In practice this would involve the valuation of capital assets for each tax year, so imposing a considerable administrative burden. It would also involve the risk that individuals might be forced to liquidate assets in order to pay the tax which might involve undesirable outcomes regarding business assets. In the UK, CGT avoids such problems because it is levied on a realisation basis. However, this also presents challenges. Taxpayers might find themselves 'locked in', in the sense they have an incentive to postpone payment of the tax by not realising the asset even when it might otherwise be economically efficient to do so. Also, because assets are realised in uneven lumps, it is difficult to make the tax progressive. This difficulty may be aggravated because capital gains, whether realised or not, may occur irregularly.

Valuation can also be a consideration. Even with the realisation basis, it is necessary to determine the value of the asset when acquired and when realised. This will often be a straightforward exercise—it will simply be the value agreed between third party buyers and sellers. For other transactions, such as the sale of an asset originally received by way of gift, determining the value of the asset (in this case when received) may be more difficult.

3.2 The United Kingdom experience

Although there had been previous attempts to tax certain types of capital gains, especially from land, the systematic taxation of gains did not begin until 1962. In that year a tax on short-term gains was introduced. In 1965 a more comprehensive CGT came into operation. The tax is levied on a wide range of assets, but there are several exemptions, including a taxpayer's only or main residence, motor vehicles and gambling winnings. The justification for exempting the last of these was that, as there is no capital asset, there cannot be a capital gain. There is also an individual annual allowance of £11,100 (in 2016–2017 this was approximately $26,500 NZ dollars).

In its early years, CGT was subject to a separate rate of tax, which was 30 per cent from 1965 to 1988. However, the argument that capital gains are a form of income

[61] HC Deb 06 April 1965 vol 710 c245 245 § The Chancellor of the Exchequer (Mr James Callaghan).

Capital gains accruing to incorporated companies are also taxed but by corporation tax on their gains rather than CGT.

Although there have been several different ways of taxing a chargeable gain, the calculation of the gain itself has remained much the same. As one might expect, this is basically the sale proceeds less the purchase cost. One way in which the gain may work out to be smaller than at first expected is due to the sensible treatment of expenses. Those paid at acquisition are added to the original costs; those paid at disposal are deducted from the proceeds.

4. LESSONS FROM THE UNITED KINGDOM

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4.1 Labour's capital gains tax policy—an iis

basis with few, if any exemptions.[70] This form of CGT has been rejected by various NZ committees, let alone other countries including the UK, as unworkable. Second, (and the approach favoured by the authors) is that it could be based on a pragmatic approach which, considering broader tax administration, tax policy and design principles, departs from the comprehensive concept of income. Compromise and trade-off will be required under such an approach but hopefully will lead to a tax that is politically sustainable. Such an approach is contrary to that adopted by the GST where the policy design strongly focussed on simplicity but will be necessary for the successful implementation of a CGT.[71]

Labour's policy has taken certain administrative issues into consideration. As noted, the CGT would be levied on a realisation basis and will thus avoid both the burden of valuing assets annually and the potentially negative cash flow impact on taxpayer's required to fund an accruals-based tax. The policy trade-off will be the potential 'lock-in' of assets. Further, the tax base is not indexed for inflation. In a period of low

	UK	NZ
	Can be carried backwards for gains at death.	Panel to consider upper limit for offset of losses.
Treatment of gains at death	No CGT but rollover provisions for heirs and taxable at market value on realisation.	No CGT but rollover provisions for heirs and taxable at market value on realisation.
Treatment of gifts	Gifts subject to CGT unless to spouse, partner, civil partner or charity.	Gifts subject to CGT. Rollover where assets transferred between a couple in relationship break-up.
Private residence exempt?	Yes	Yes
Personal property exempt?	Yes—CGT on disposal of personal possession for £6,000 or more (eg jewellery, paintings, antiques, coins and stamps, sets of things such as matching vases or chessmen). No CGT on motor vehicles unless used for busi 9 Tc uynn BT 0.002 Tc 0.237 Tw -2.3 (36.4 58p8)1.9	

and Davey's NZ study.[77] There are two very practical tax administration impacts from the introduction of a tax-free threshold. First, it 'has the advantage of

presently does not tax capital gains, this is a move toward vertical equity.[86] However, equity concerns remain. While there is clear rationale for the 15 per cent CGT rate, the low rate 'negates many of the benefits of introducing the tax'.[87] The reality is that as it is lower than three of the present four tax brackets for individual taxpayers—in fact, half or less than the top two rates—an arbitrage opportunity will exist between income from capital and income from labour. This will lead to horizontal inequity and impact on the administration of the tax. The difficulties that exist in differentiating between income and capital in the current NZ tax system absent a CGT 'will continue to be perpetuated despite the introduction of a CGT'[88] under Labour's proposal. In addition, on the basis that capital gains tend to be derived by higher wealth individuals, the effective concessional tax rate for capital gains will benefit that group more.

In terms of tax design, these equity concerns could be addressed to a degree in NZ through the adoption of a more progressive CGT scale as utilised in the UK. This could be achieved through the adoption of two measures, the first, discussed in Section 4.2 of this paper, is the introduction of a tax-free threshold. The second measure would incorporate into the CGT regime at least one additional tax rate for capital gains above a certain level. As a variation of this, to further address issues of equity, a higher rate(s) could apply to owners of multiple residential properties—the approach recently adopted in the UK for tax policy reasons.

Introducing differential CGT rates, based on the level of capital income and/or number of properties, will have trade-offs. While it focusses on the tax principle of equity, the complexity of the CGT will increase which will impact on the administration of the CGT, particularly for taxpayers in determining their actual CGT liability. Tax returns and the tax system would need to accommodate any such measures (including the need for potential audit activities). To avoid imposing such levels of complexity capital gains could be treated as ordinary income subject to the existing individual income tax rates. In addition, rather than, for example differential rates for muuTj 0.0 m(i)-4.(l)8l

As a consequence, and as indicated in Section 4.2, the authors favour a separate CGT with a tax-free threshold. This will ensure a level of progressivity with the CGT. Multiple CGT rates could also be introduced depending on the strength of the equity concerns to be addressed by the CGT. However, in addition to the complexity and tax administration issues noted above, differential rates could also encourage manipulation to avoid the higher rate(s). Therefore any decision to include more than one CGT rate will require careful consideration.

4.4 Tax appeasement – the main residence exemption

In line with the UK (and other CGT regimes), Labour's 2014 policy statement provides an unlimited exemption for the main residence. This tax policy measure reflects overseas experiences that suggest 'an exemption for the primary residence is needed in order to garner support and make the introduction of a CGT politically palatable'.[89] Holiday homes would be included as part of the CGT regime (except where passed down from one generation to another) as to exempt them would lead to loopholes, as well as definitional and administrative issues.[90] Where the main residence was also used for business purposes, there would be a partial exemption from the CGT for that portion of the property used as the family home.[91] Similarly, in

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whether investment in such collectables is to be encouraged. As a tax policy consideration, arguably these are generally not the types of assets that a nation wants to incentivise investing in; instead, tax policy should focus investment into productive sectors of the economy, encourage investment and innovation as well as the creation of jobs. One of the key reasons a CGT is promoted by Labour (along with some commentators) is that it 'will help shift the focus of investment from speculation on property to the productive export sector'.[120] The exemption of collectables is clearly

the administration of the tax. Despite this a UK approach to 'collectables' can be justified when the focus is on tax policy and tax principles.

An alternative approach to address the concerns over determining who is (or is not) a dealer, would be to treat all gains from the disposal of personal property as ordinary income subject to income tax. While this would remove the boundary issues referred to above, and therefore positively impact on one aspect of the administration of the tax, in the absence of a tax-free threshold for ordinary income, this treatment would also impose compliance costs on taxpayers deriving small gains and administrative costs for Inland Revenue. This, in turn, would undermine the political sustainability of any such measure.

4.7 'Remember the little fella'—business oncessions

The 2014 policy statement proposes the exemption of '[s]mall business assets, up to a maximum of $250,000, sold for retirement, where the owner is above a certain age (e.g. 55) has held the business for 15 years and has been working in the business'.[122] The term 'small business' is not defined. This and other details would be considered

or forcibly—to fund their retirement, and subject to the caveat that the CGT-free business disposals be integrated with the superand(r)6.9 (.7 (hs)10.6 (p)2m99 (d(r)6)0.c)17.50 0 11.0

acquired within 3 years of the disposal of the original assets. Further, under the Gift Hold-Over relief, no CGT arises where business assets are given away or sold for less than they are worth.

Evans and Sandford argue on equitable grounds that rollover 'provisions need to exist where involuntary disposals occur (compulsory acquisitions, corporate takeovers and mergers, destruction of assets through natural disasters, etc)'.[131] Similarly, on efficiency grounds they argue 'for deferral of the capital gain where taxpayers are rolling the proceeds of the disposal of one asset into a bigger asset, in order to grow a business'.[132]

Aside from Evans and Sandford's arguments in favour of the very specific

BBLR and its consequential focus on simplicity and broad coverage will therefore be required. It is clear from a consideration of the UK CGT regime that it introduces significant additional complexity into the tax system, due in part to policymakers introducing specific concessions. While in a ‘pure’ system such exemptions and concessions should be limited to minimise complexity and opportunities for tax planning, from an administration perspective there are a strong arguments for some relief, such as a tax-free threshold, to reduce compliance and administrative costs.

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should keep in mind Gammie's caution: '[a CGT] is a compromise, and, as is so often the case with a compromise, it functions badly and pleases no one'.[136]

The near future would be an ideal opportunity to implement a CGT in NZ as the Inland Revenue has embarked on the Business Transformation programme (referred to in Section 4.0). This 10-year programme[137] involves changes that 'will simplify and streamline [Inland Revenue's] business processes, policies and customer services as well as upgrade [Inland Revenue's] technology platform'.[138] Any future CGT design should benefit from the fruits of the Business Transformation programme with its focus on tax administration considerations.

The introduction of the goods and services tax in NZ in 1986 'suggests that a politically controversial new tax can be implemented in New Zealand, with exemptions that depart from the theoretical ideal, but not disintegrate over time'.[139] New Zealand is in a unique position. As a late adopter of a CGT it has the advantage that it can look to the practices of other jurisdictions including the pragmatic approach of the UK. Two related lessons can be drawn from the UK experience. First, tax policy, principles and tax administration all have an important role in the design, reform and operation of CGT. Second, it is not easy to separate each aspect with regard to each individual feature of the UK CGT. Often all three dimensions are involved and sometimes in more than one way. The relationship between the three is therefore a close and complex one and trade-offs are required. With respect to the NZ proposals, the UK experience is that all three dimensions (tax policy, tax principles and tax administration) should all be carefully considered. In addition, as the UK experience demonstrates, a successful tax policy also has to take account of political realities.

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[136] Malcolm Gammie, 'Taxing Capital Gains—Thoughts from the UK' (2000) 23 *University of New South Wales Law Journal* 309.

[137] Paul McBeth, 'IRD's Business Transformation Project to Come in Under Budget', *The National Business Review* (online), 11 November 2015 <http://www.nbr.co.nz/article/irds-business-transformation-project-seen-coming-under-1-billion-b-181435>. In fact, the programme is ahead of schedule and may be completed in 7 years.

[138] Inland Revenue, above n 79.

[139] Huang and Elliffe above n 32, 304.