SPEAKMAN LAW

Capital gains tax…

Labour has announced its intention, if elected, to introduce a capital gains tax in New Zealand at 15%, with a carve out for your principal home. Many people have asked me what this would mean, so here are some thoughts.

A natural assumption is that capital gains tax would only be imposed when those gains are realised. Another assumption is that the recipient of the gain will have no trouble paying the tax amount because the recipient will have ample funds/cash from the sale with which to do so. Are these assumptions correct? No, not in every instance.

It might well be the Labour Party's intent that capital gains tax is only to be imposed when gains are realised. But what about transfers (of land for example) to an associated company in the course of a restructuring (say, to separate investment properties from those that are intended to be developed and sold). Likely, no cash would be paid (immediately at least) on that transaction, yet the selling company would probably have a tax liability (I say probably because the laws have not yet been written of course so we can't be definitive).

Or, take for example distribution of a capital asset by a company on liquidation. Would the distribution to the shareholder be considered "realisation"?

Or take a partnership that admits a new partner. Upon doing so, the existing partners' interests in the partnership become diluted. This effectively is a sale by the existing partners of part of their interest in the underlying assets (including capital assets) held by the partnership. A capital gains tax, if imposed, would seem to be triggered here for the existing partners. Yet they will, in the ordinary course, have no cash to shelter the tax liability.

Or take options over shares granted to a person. Are the options considered to have been realised when they are granted? Or upon exercise? The latter is more likely, but all the person has done is convert options into shares. No cash is generated on that transaction so there remains no cash to shelter the tax liability (this result is similar to our fair dividend rate (FDR) regime which those of you who have interests in foreign equities will be familiar with; under FDR you are taxed on notional dividends which you don't in fact receive, and indeed are taxed regardless of loss in the value of those foreign equities).

Or take a share for share swap? Same issue. What about capital gains made overseas? Should these be taxed here? If so, what if the proceeds are not brought back to New Zealand? Often this will not be directly within a person's control. So is it right to tax these amounts when the seller generates no cash with which to pay the tax?

Might a capital gains tax be imposed on unrealised/accrued gains? Perish the thought. Who could afford to finance the tax that would be payable each year? Would a bank be prepared to fund capital gains tax payments where gains are unrealised and would such a system force sales of capital assts (undoubtedly this would be disastrous for business/capital investment). It might be a surprise to readers to know that New Zealand has exactly this system already, ie a tax on accrued capital gains. This applies to debt instruments (long term bonds for example) and foreign exchange gains. It also applies (in limited form – only 5%) under our FDR regime for taxing foreign equities, mentioned above.

But don't other countries such as Australia, and the US have a capital gains tax regime? Surely they have dealt with these issues? Yes they do have a capital gains tax regime. They deal with these issues by extensive exemptions/carve outs which result in the applicable legislation spanning hundreds of pages.

In short a capital gains tax system, while it sounds simple enough, is extremely complex. Businesses here struggle enough already with the complexity of our tax system. A capital gains tax system would add a whole new layer of complexity and compliance costs for businesses and I for one do not think now is the right time for that. Nor do I believe a capital gains tax system would be good for the country as an investment destination for foreign investors. Understandably the prospect of a capital gains tax exposure would be a big turn off for them.

These are just my humble thoughts and observations. You will all have your own thoughts, at the least I hope you find mine stimulating.