EXPLORATIONS OF STRUCTURE AND CHOICE IN TAXING CAPITAL GAINS: NEW ZEALAND TAX EXPERTS' PERSPECTIVES

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Abstract

This study explores the key issues, aspects, and attributes concerning capital gains tax (CGT) to enable the formulation of policy guidelines that might be used if a CGT were considered in New Zealand. It contends that the development of the New Zealand's policy on taxing capital gains has continued in a somewhat ad hoc and inconsistent fashion. The lack of a uniform approach to capital gains taxation has resulted in detailed, but complex, legislation which leads to "policy inconsistencies and unintended incentives built into the tax structure" (Oliver, 2001, pp. 80 – 81).

The study bridges the divide between theoretical analysis of CGT and implementation issues on operating a CGT. It attempts to address one primary research question and an associated secondary question. The primary research question is: should capital gains be taxed more comprehensively than at present? As a start, it examines the two important issues surrounding income definition and the capital/income distinction. In this regard, the research first attempts to identify the definition(s) of capital gains from the New Zealand perspective(s). This is followed by investigating the key areas of the tax system in order to seek the best way of taxing capital gains.

This study also attempts to address the secondary research question, i.e., why (or why not) do the tax experts favour (or oppose) a comprehensive CGT? In this respect, this study identifies 23 factors/issues that are related to the tax experts' attitudes towards a particular form of a CGT model (i.e., current hybrid approach, a realisation-based CGT or an accrual-based CGT).

A mixed-methods design has been adopted in this study involving both a quantitative (survey) and a qualitative (interview) method in analysing the data to determine the tax experts' overall perceptions of a CGT in New Zealand and the CGT adoption factors which influenced them.

One important finding of the comparative analyses was that all tax experts generally agreed that the lack of a comprehensive CGT could provide more significant tax planning opportunities. However, many tax experts did not support

the comprehensive income concept as they disagreed with the benefits derived from the gains in horizontal equity through adopting a CGT.

This study has identified several important policy issues and reviewed their implication for the adoption of a CGT in New Zealand. The finding of the study revealed that the tax experts strongly supported the exemption of the gains on disposal of a taxpayer's main residence and the tax preference for inflation adjustment. Another important policy issue is the implementation of an accrual-based CGT. Most tax experts considered a realisation-based CGT would be better than an accrual one. In particular, they were concerned about the liquidity problems and the compliance costs involved in an accrual-based CGT regime i.e., the annual valuation of all assets.

These findings represent a first step towards a theoretical CGT framework. It is hoped that the knowledge gained in this study would give a greater understanding into the practical decision-making process that could result in a better public acceptance for a tax reform.

Acknowledgements

This study would not have been possible without the cooperation of the 33 New Zealand tax experts who were willing to participate in both the survey and the interview. The tax experts had allowed me to ask them questions about the various areas in taxation that had potentially impacts on the taxation of capital gains. They gave their time freely while having many commitments of their own. The quality of the results of this study is a direct consequence from the input of these people.

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Chapter 1 Introduction

1.0 Preface

It is generally known that New Zealand does not have a comprehensive capital gains tax (CGT [1]). Income tax is imposed on personal, business and investment income, while capital gains are subject to income tax only in limited circumstances. This regime makes New Zealand "unusual" among the countries in the Organisation for Economic Co-operation and Development (OECD) in not having a comprehensive form of capital gains taxation (Oliver, 2001). Many countries have long discussed the costs and benefits of introducing a general CGT and have also begun taxing capital gain comprehensively.

While New Zealand has no formal CGT, the reality is that certain capital gains are collected as taxable income under the Income Tax Act 2007 (ITA 2007). In other words, New Zealand does not have an explicit CGT but does include income that would otherwise be treated as capital gains in other jurisdictions. This approach was described by the Committee Against Capital Taxes (CoACT) (1989) as "a strategy of capital gains taxation by stealth" (p. 11).

Over the years, attempts have been made by the New Zealand Government to capture more "capital gains" within the tax net by widening the tax base through the introduction of specific legislation, even though the development of the New Zealand's policy on taxing capital gains has continued in a somewhat "ad hoc" and "inconsistent" fashion (Burman & White, 2003). The lack of a uniform approach to capital gains taxation has resulted in detailed and complex legislation which leads to "policy inconsistencies and unintended incentives built into the tax structure" (Oliver, 2001, pp. 80-81).

In general, capital gains are not taxable unless the types of gain are specifically taxable under the ITA 2007. As such, the income/capital distinction plays an

[1] The term "CGT" is referred to as a comprehensive form of CGT and focuses on the taxation of gains derived from disposal of any asset not just a particular class of asset.

important role in the application of the Act. In practice, however, such distinctions can be extremely difficult to identify (Maples, 2005). The problem is that the Act does not define precisely the terms “income” and “capital” and it is left to the Court’s discretion to determine the nature of a tax transaction. There is no general agreement on how capital gains should be charged. Since it is difficult to define exactly what capital gain is, no single criterion has emerged to identify the nature of a receipt and so the analysis will vary according to the facts of the case. The decisions in these cases have determined only that, at best, the income/capital distinction is an elusive concept (Burman & White, 2003).

Moreover, intense debates on CGT have taken place in most industrialised countries, for example, the United Kingdom and Australia for nearly half a century. These debates have shed light onto the issues surrounding this subject. It is important to consider the design of tax systems in these countries, since New Zealand is increasingly using its tax system to improve its ability to compete globally in open economies. In particular, the mobility of capital income tax bases due to globalisation may also increase the opportunities for tax avoidance and evasion.

Added to this, income from the provision of labour is taxed in full, while most capital gains are tax exempt. Such asymmetric treatment raises the incentive for taxpayers to employ tax avoiding devices, thereby converting otherwise productive private sector resources from taxable income into non-taxable capital gains. In economic terms, doing so is inefficient and distorts the principle of equity. Since the introduction of a higher income tax rate on high income earners in 1999, such a policy has deepened the inequities created between taxpayers who earn income from labour and those who earn income from capital gains.

Therefore, the weak tax legislation for taxing capital gains, the elusive concept of income/capital distinction, the external influences in international taxation, and the inequity of the current system have all resulted in the need to re-examine the issue of introducing a comprehensive CGT in New Zealand.

1.1 Problem statement

The primary research question of this study is:

> Should capital gains be taxed more comprehensively than at present?

From this follows the secondary research question which asks:

> Why (or why not) do tax experts favour (or oppose) a comprehensive CGT?

As the research topic is diverse, the scope of the research was limited to the policy makers' level and not to the general public level. Emphasis was therefore placed on investigating the attitudes of New Zealand tax experts. This investigation involved discussion on their thinking about how the tax system copes with the problems of CGT and the identification of those factors related to their preferences for a particular measure of a CGT model (i.e., current New Zealand-style CGT approach, a realisation-based CGT or an accrual-based CGT). Their expert knowledge in these areas has played an important role in tax policy design, and implementation of a comprehensive CGT.

For the purposes of this study the following definitions are used:

Capital Gain: A capital gain is defined as the increase in value of a capital asset. This includes any gain on capital account or capital income. It can be realised or unrealised (accrual).

Capital Gains Tax (CGT): In this study, the term refers to a broader form of capital gains tax (CGT) which includes any form of taxation of capital gains, such as the New Zealand-style CGT and the comprehensive CGT.

Capital/Income Distinction: This term means the differentiated judicial treatment of capital gains and income under the New Zealand tax system.

CGT Factors/Issues: The factors/issues that relate to a tax expert's preference in adopting a particular type of CGT are covered by this term.

CGT Proponents/Opponents: The CGT proponents are the group of tax experts who support the introduction of a comprehensive CGT system, while CGT opponents are those who oppose such a tax.

Comprehensive Income: According to the Haig-Simons' definition of income, the comprehensive income concept embraces both income on revenue account (ordinary income) and income on capital account (realised and unrealised).

Comprehensive Capital Gains Tax: This tax involves a comprehensive taxation of capital gains. The tax can be levied either on a realisation basis or on an accrual basis. A realisation-based CGT is a tax system where capital gains are taxed when they are realised i.e., the tax is triggered when a taxpayer sells or disposes of a property. On the other hand, an accrual-based CGT system taxes the annual unrealised capital gain of a taxpayer's asset, which is computed as the difference between the fair market value and its cost. It does not matter if the taxpayer has not in fact sold/disposed of the asset.

Income: Unless specifically provided, this term generally refers to the income on revenue account or ordinary income.

New Zealand-style CGT: Certain types of gains – that would normally be regarded as capital gains – are specifically deemed as ordinary income and, therefore, are taxable under the current New Zealand tax system. This way of taxing capital gains is referred to as the New Zealand-style CGT.

1.2 Research objective and issues

The objective of this study is to explore the key issues, aspects, and attributes concerning CGT in New Zealand to enable the formulation of policy guidelines that might be used if a CGT were considered in New Zealand.

The purpose of the study is to provide an overview of current thinking for policy making. This outcome was achieved by looking at the issue of taxing comprehensive capital gains in the wider context. Thus, it is hoped that this research will enrich the literature by revealing the possibilities, and the likely difficulties, of implementing a comprehensive CGT in New Zealand.

As part of the process of achieving the objective, this study addressed one primary research question and an associated secondary question. The primary research question is to ask to what extent capital gains should be taxed in New Zealand. In particular, this study considers the issue of taxing comprehensive capital gains in a wider context by looking at the areas (or types of assets) where a CGT could be applied.

As a start, attempts were made to identify the key areas of the tax system that are related to the taxation of capital gains. A review of current literature suggests that most countries, particularly Organisation for Economic Co-operation and Development (OECD) countries, have adopted a realisation-based model. In this respect, this research will look at six major design issues, i.e., (1) CGT assets coverage; (2) realisation- versus accrual-based taxation; (3) treatment of the inflation component of capital gains; (4) CGT tax rates; (5) capital losses treatment; and (6) timing and rollover provisions. As some previous New Zealand Government's Tax Committees (Valabh Committee, 1989; McLeod, 2001b) had indicated that there were sound theoretical grounds to introduce an accrual-based CGT system, the research will try to examine the major implementation issues of an accrual-based CGT such as the measurement and the liquidity problems.

Two related matters are the issues surrounding income definition and the capital/income distinction. The problem with the current tax system is that certain types of capital gains – that would normally be regarded as capital gain in other jurisdictions – are in New Zealand deemed to be income. This approach has resulted in an ambiguous capital/income distinction. Moreover, the absence of a comprehensive CGT places New Zealand in an almost unique situation when compared with other OECD countries. In this regard, the research will attempt to identify the definition(s) of capital gains from the New Zealand perspective(s).

In order to gain better public acceptance for a tax reform, it is important to build a consistent policy framework which should guide the setting of new tax policy. This involves consideration of an appropriate balance from amongst all the CGT adoption factors. In this respect, this study will address the secondary research question, i.e., why (or why not) do tax experts favour (or oppose) a comprehensive CGT?

Answering the question requires a close examination of the factors that are related to tax experts' attitudes towards a particular measure of a CGT model (i.e., current approach, a realisation-based CGT or an accrual-based CGT). This exploration involves an analysis of the possible tax structure and the reasons behind the adoption decision. It also includes examination of taxation factors (such as current tax rate structure, tax burden) and non-taxation factors (such as social and political ones). Finally, the research seeks to reveal the characteristics of "a good tax" practice from the tax experts' perspectives.

1.3 Methodology and method

A mixed-methods design was adopted in this study involving both a qualitative and a quantitative method in analysing the data to determine the tax experts' perceptions of a CGT in New Zealand and the CGT adoption factors which influenced them. The data collection was undertaken in three phases, in the period between 25 August 2004 and 28 April 2006.

The first phase of the research involved conducting a questionnaire survey. In all, 558 questionnaires were distributed to two different groups of tax experts, i.e., tax teachers and tax practitioners. Subsequently, 175 usable questionnaires were received. Data were then aggregated to create a single base of tax experts for compiling a statistical analysis. Two major groups of tax experts were subsequently identified, namely, the CGT proponents and the CGT opponents. This was used to examine factors that affected tax experts' attitudes to a CGT model by comparing their opinions.

Phase two of the research involved interviewing the tax experts. Respondents to the main survey were invited to participate in the individual, face-to-face, follow-up interviews. In total, 33 tax experts were interviewed. Coding was used for the qualitative analysis in order to identify the phenomena and to establish a taxonomy of factors that influenced the tax experts' decision making in the CGT adoption.

Finally, phase three of the research compared the results in phase two with those in first phase. Possible biases that could result from these phases were discussed. Precautions taken to minimise biases were also explained, together with the information discovered through the literature review. The final comparative results provided a basis for the discussion about the tax experts' overall views on CGT and their thinking behind it.

1.4 Outline of thesis

Chapters 1 and 2 provide the essential framework for the research. The introductory chapter gives a brief background of CGT and outlines the thesis. Chapter 2 looks at the definitions of "income" and "capital gain" and is followed by a discussion of the issues surrounding the income/capital distinction. The reasons for and against a CGT in New Zealand are then considered in the light of the traditional criteria of equity, efficiency, and simplicity. Following a brief overview of the development of taxation of capital gains in New Zealand and other countries, a detailed analysis of the technical issues of a CGT that have been found and widely discussed in other countries is provided.

Chapter 3 covers the approaches followed by previous literature which contributed to developing the methodology of the thesis. The chapter explains the research methodology and methods employed in this research project. It also provides a detailed discussion of the mixed-methods approach. The quantitative and qualitative data results are contained in Chapters 4 and 5 respectively. Chapter 6 presents the summary of comparative results and reviews several important policy issues. Finally, Chapter 7 concludes the research findings.

1.5 Scope, assumptions, and limitations

1.5.1 Scope

This research focused on investigating the attitudes of New Zealand tax experts towards a comprehensive CGT. The topic is, of course, a diverse one as it encompasses many things such as economics, culture, history, and politics. Consequently, scope of the research was limited to the tax policy-making level i.e., aspects of tax policy design and implementation, and included a revision of the tax system to cope with the problems in respect of taxing capital gains.

1.5.2 Assumptions

It was assumed that all tax experts in the research surveys and interviews were honest in their views on CGT and their adoption decision. Moreover, their interpretation of various aspects of a CGT might vary depending on their previous exposure and experience of overseas CGT systems. It was recognised that bias could occur when the tax experts had forgotten the key information in retelling their experience. In some extreme cases, they might omit or even alter key information in their retelling in order to attract attention.

1.5.3 Limitations

It was difficult to identify the entire population of New Zealand tax experts as there is no single dominant professional body monitoring the practice of tax consultancy. As such, this study was targeted at the tax experts who had good knowledge of the New Zealand tax system. Its scope was purposely limited to only tax teachers, tax accountants, tax agents and tax lawyers who all had working experience in tax practice for 3 years or more. This limitation allowed the study to be manageable.

In addition, the sample was further restricted to include tax experts from the private and the education sectors (such as tax teachers, registered tax agents and professional accountants). Tax experts from other sectors such as the public sector (e.g. the Inland Revenue and the Treasury) have been excluded. Hence, it was recognised that this limitation could bias the results and limit the generalisability of this study.

Regarding the examination of the relationship between the tax experts' perception and their CGT adoption factors, the exploratory nature of this study has limited its powers to explain and predict the relationship. While the study's results were relevant to the study of the tax experts' attitudes, no direct cause-and-effect relationship could be established.

Lastly, all interview data were collated and analysed by the researcher. While methods were employed to enhance the validity of findings, it is acknowledged that the results could be prone to bias and error due to the subjective nature of the research. As a result, this possible subjectivity might undermine the ability of the results to be transferable to other similar case studies.

Chapter Two Literature review

2.0 Introduction

New Zealand has three major sources of tax revenue: 1) the personal income tax, 2) the Goods and Services Tax, and 3) the Company Tax. According to the Inland Revenue's annual report 2008, income tax (PAYE) accounted for 45% of the total tax revenue for the 2006-07 tax year, Goods and Services Tax 19%, and Company Tax 18%. The remaining 18% came from other taxes such as resident withholding tax, exercise duties, custom duty, road user charges, gift and cheque duties, etc. (New Zealand Inland Revenue, 2009). New Zealand has neither a comprehensive capital gains tax (CGT), nor an inheritance tax, and the only form of capital taxation is the gift duty which makes New Zealand "unusual" among the countries in the Organisation for Economic Co-operation and Development (OECD) in not having a comprehensive form of capital gains taxation (Oliver, 2001). Many developed countries, and even the underdeveloped ones in Africa, have had long discussions about the costs and benefits of introducing a general CGT and have also begun taxing capital gain comprehensively.

Ambiguity has long been a defining characteristic of the taxation of capital gains in New Zealand. There has always been a gap between public perception and reality. Under the common understanding of the classical income concept, capital gains have always been excluded from the tax base and are regarded as an integral part of a person's permanent capital that ought to be preserved. To reinforce the image of New Zealand as a capital gains tax-free country, even the New Zealand Inland Revenue (2007a) claims "there is no capital gains tax" in New Zealand when it compares the New Zealand and Australian tax systems on its website. However, although New Zealand has no formal CGT, the reality is that there are more than 10 instances[2] under the New Zealand Income Tax Act 2007 (ITA 2007) where both realised and unrealised capital gains are collected as assessable income. These include but are not limited to:

1) gains from the sale of personal property

[2] More discussion is given in section 2.2.

2) profits from land sales
3) accrued income from debt instruments
4) investment income earned through foreign investment funds
5) income from restrictive covenants and inducement payments of employment.

In other words, New Zealand does not have an explicit CGT but includes income that would otherwise be treated as capital gains in other jurisdictions. This position was described by the Committee Against Capital Taxes (1989) as “a strategy of capital gains taxation by stealth” (p. 11).

It is evident that over the years the New Zealand Government has brought more “capital gains” into the tax net by widening the tax base through the introduction of new, specific legislation. As observed by Burman and White (2003), New Zealand’s policy on taxing capital gains has developed in a somewhat “ad hoc” and “inconsistent” fashion. The lack of a uniform approach to capital gains taxation has created detailed and often complex legislation. The end result is that this situation leads to “policy inconsistencies and unintended incentives built into the tax structure” (Oliver, 2001, pp. 80-81). The default rule is that capital gains are not taxable unless the types of gain are specifically taxable under the ITA 2007. As such, the capital/income distinction is one of the keys to the interpretation and application of the ITA 2007. In practice, it can be extremely difficult to distinguish between capital and income (Maples, 2005). The Act does not define precisely the terms “income” and “capital” and it is left to the court’s discretion to determine the nature of a transaction for tax purposes. This situation has often led to the fate of the taxpayer being decided by the judgement of the court, since there is no single criterion to identify the nature of a receipt, and the analysis will vary according to the facts of each individual case (Holmes, 2008).

In some circumstances, such as debt instruments and foreign investment funds, New Zealand taxes all capital gains on a full accrual basis while countries with CGT normally tax realised profits only. The extent to which capital gains are taxed depends on the types of assets under consideration. While there are inconsistencies among different types of assets, the specific provision itself is not without problems. For example, under the foreign investment fund (FIF) regime, capital gains incurred by a New Zealand shareholder of an Australian company are not taxed, whereas capital gains incurred by another New Zealand shareholder of a company in a country such as the United Kingdom is taxed on an accrual basis (the fair dividend rate rule “FDR”). To add even more complexity to the tax system, in order to be eligible for the exemption of the FIF regime, the law requires that the Australian company must be an Australian resident company and maintain franking accounts and be included within an approved index of the Australian Stock Exchange.

The inefficient legislation for capital gains taxation together with the elusive concept of capital/income distinction, has resulted in the need to re-examine the issues of introducing a comprehensive CGT in New Zealand. There has in fact been a wide discussion in the literature about taxation of capital gains in New Zealand. The purpose of this chapter is to review the literature and to look at the tax coverage of capital gains in the current tax system. The sections of this chapter are as follows:

Section 2.1 looks at the definition of “capital gain” and is followed by Section 2.2 which touches on the issues surrounding the capital/income distinction by way of examples drawn from the New Zealand experience. Section 2.3 provides an overview of the development of capital gains taxation in New Zealand by looking at previous major government reports. It will examine the arguments of each of the reports which were traditionally used for and against a CGT. Section 2.4 provides a brief overview of the contemporary issues surrounding the taxation of capital gains in OECD countries. Section 2.5 then provides a detailed analysis of the technical issues of a CGT that have been widely discussed and found in countries with CGT. In section 2.6, a review of the three theoretical models: namely, the comprehensive income theory, the optimal tax theory, and the public choice theory is provided to aid the evaluation of the CGT policy measures.

2.1 The meaning of “capital gain”

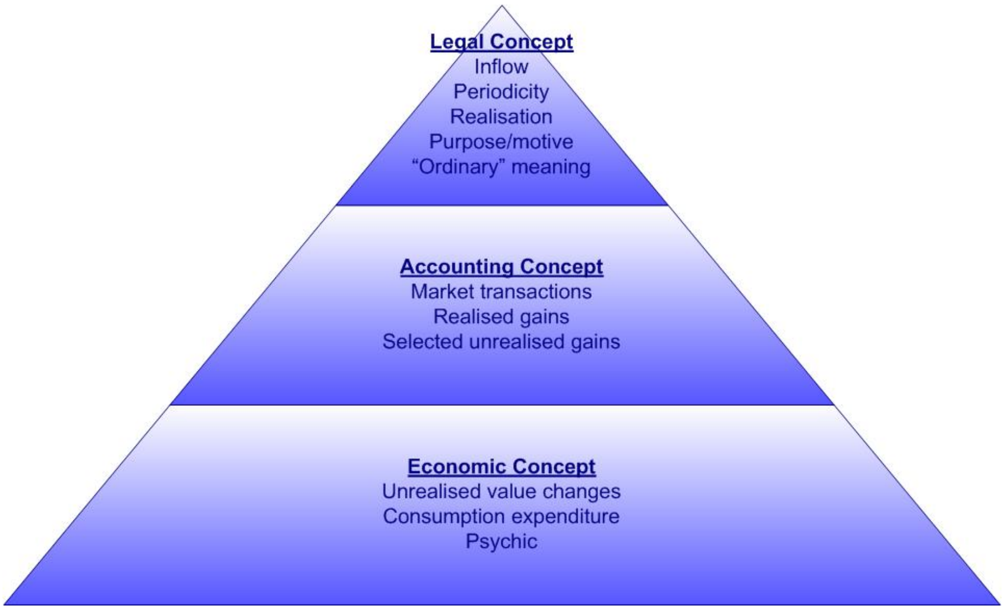
In simple terms, a capital gain is defined as the increase in value of a capital asset (Rossini, 1998). This basic concept appears to be simple. Yet the reality seems the opposite. Despite many developed and developing countries introducing CGT many years ago (the first CGT regime was introduced in Norway in 1911), the term “capital gain” remains vaguely defined in the global context. While the term “capital gain” is frequently used in the tax systems across the world, the “precise contours of the concept vary considerably from country to country” (Ault, 1997, p. 194). Concepts of capital gain in the tax literature are diverse, and, therefore, there is no single definition of what capital gains are (Andersson, 1991; Bracewell-Milnes, 1992; Evans, 2002).

The lack of consensus as to the meaning of capital gain is further emphasised by Evans and Sandford (1999). These authors examined the taxation of capital gains in six English-speaking countries (i.e. Australia, Canada, Ireland, New Zealand, the United Kingdom and the United States) and found that the legal definitions used for capital gain were different in those countries. The result showed that “it is virtually impossible to identify any unifying principle in taxing capital gains” (p. 394).

In the context of the New Zealand tax system, the theory of capital gain, which is a subset of the income concepts, has been derived from 1) economic concepts, 2) accounting concepts and 3) legal concepts. Holmes (2001) described the development of the concept of income, as encompassing all various forms of income and gains, including capital gain, as an income pyramid. At the bottom of the pyramid, there was the broadest notion of income, or the psychic income. The economic definition and the psychic income were the foundation concepts of income. At the second level of the pyramid were the accounting definitions of income. Although the accounting definitions of income were generally based on the foundation concept of income, the concepts had a narrower focus as emphasis was placed on the importance of objective valuations. This approach resulted in the exclusion of certain unrealised gains (such as accrual capital gains). At the top of the pyramid was the legal concept of income. The legal definitions of income were heavily influenced by both economic and accounting notions of income. However, compared to the economic or accounting concepts, the legal concept was much narrower as it excluded many real economic gains or benefits, due to the judicial requirement. For instance, New Zealand courts have traditionally excluded realised capital gains from the determination of business income for tax purposes. As Holmes (2001) explained, there had been an increasing exclusion of items that comprised income as one moved from the economists' notion of income through the accountants' concept of income to the legal concept of income (pp. 240 – 242).

Holmes' Income Pyramid is illustrated in Figure 2.1 below.

Figure 2.1 Holmes' Income Pyramid



In the following sub-sections, Holmes' income pyramid approach is adopted to provide detailed analysis of 1) the economic perspective, 2) the accounting perspective and 3) the legal perspective of capital gain.

2.1.1 Economic perspective

During the late nineteenth century, economists developed various income concepts, with emphasis on the ideas of psychic income and utility. However, the vague, subjective, psychic income was difficult to implement for tax policy analysis. Later, economists made the notion of psychic income more practical by substituting monetary flows. As a concept, the economic definitions of income, which served as a proxy for psychic income, emphasised the consumption, or a combination of consumption and changes in net wealth (such as capital gains) over a period served (Schanz, 1896; Seligman, 1926; Kaldor, 1955).

In simple economic terms, income is the flow of earnings received by an individual. It is derived from 1) human capital – which represents intangible assets like accumulated skill and knowledge of human beings and 2) non human capital – which is often referred to as "wealth" or the physical and financial assets traded on capital markets (Parkin, 1994). Income is the flow of earnings that results from the stock of wealth.

One of the predominant schools of thought in income concept was Fisher's concept of income (Fisher, 2006). This economic view of income was based upon the classic definitions of "income" and "capital" that were propounded by early political economists such as Thomas Malthus and David Ricardo. Fisher defined income as the "flow of services through a period of time" and capital as the "quantity of wealth existing at a particular instant of time" (Fisher, 2006). Income was the flow of services that resulted from the stock of wealth owned by individuals. In other words, services were the result of the capital. His focus then was on "services" instead of the changes in "capital". Accordingly, "capital gain" was a change in "capital" and was, therefore, not a "service", and hence not an income. Streams of services explicitly excluded capital gains. The Fisher approach would not have supported a CGT because a tax on capital gains represented a "double taxation" (Graves, 1939, p. 349).

While the Fisher notion of income focused on taxing streams of services (which primarily arise from consumption expenditure), other economists began to develop a notion of income in terms of changes in wealth over a period (i.e., wealth accrual). Among them, Robert Haig was a leading advocate of full capital gains taxation. Haig defined income as "the total accretion in one's economic strength between two points of time" (Haig, 1959, p. 67). Drawing on Haig's idea of applying a person's economic power, Simons (1938) developed a similar concept of income. In Simons' words, income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question” (p. 50). In other words, income is the net increases in wealth plus consumption over the taxable year. This core concept of income became commonly known as the “comprehensive” income or the “Haig-Simons” concept of income. Most predominant accounting income concepts such as the Hicksian income, (which will be discussed in section 2.2.1) are derived from the premises of this “comprehensive income”.

Theoretically, the Haig-Simons’ comprehensive income approach recognises that capital gains, whether realised or unrealised, represent an accretion to wealth – they are merely another form of income and therefore need to be included in the income base for tax purposes.

In the context of New Zealand’s tax system, the Haig-Simons’ comprehensive income concept is well recognised by the New Zealand government and academic tax experts. It is often referred to as “economists’ generally accepted notion of income”, even though there are other well-established income concepts in the economic literature, for example, the Fisher notion of income. Nonetheless, the concept is particularly important in New Zealand because New Zealand does not have a comprehensive CGT (Claus, Jacobsen, & Jera, 2004). As stated in one New Zealand Treasury working paper, reference to the economic definition is “valuable in assessing the objectives and impact of the current capital-revenue boundary, in providing a basis to motivate change and in evaluating proposals for change” (Claus et al., 2004, p. 20).

New Zealand, however, does not use the exact definition of comprehensive income. In reality, it is impractical, and almost impossible, to apply the ideal Haig-Simons’ comprehensive income concept. In theory, the ideal version of the comprehensive income should include all realised and unrealised changes in wealth (expressed in terms of market values), which will result in neutrality across investments. In practice, comprehensive income cannot be fully taxed. Two major problems in implementing the income concept are: timing and measurement, i.e., “when” and “how” to account for increases and decreases in wealth.

In addressing the "when" factor, a taxpayer's life-time income earning activities have to be divided into fixed equal periods of time (i.e., a taxable period of 12 months) to assess the change in wealth. This period is arbitrary from the economic perspectives (Prebble, 1996) and could lead to dissimilar tax treatment for taxpayers who are, from a long term perspective, in the same economic income and wealth position.

As regards the "how" factor, there are three generic measurement problems in using a comprehensive definition of income as a tax base (Wilson, 2002). These are: (i) there is no proper market to obtain objective market prices, (ii) the taxable income is accrued and not realised by the owner in cash or some other liquid form of wealth and (iii) there is uncertainty or a complex adjustment and an attribution is often required to determine the taxable income. Some of these problems can be resolved through the introduction of the accounting concepts, which limits most of the changes in wealth that are taken into account in the tax system. This accounting notion of "income" has helped to shape the New Zealand tax system and is discussed in the next section.

2.1.2 Accounting perspective

The New Zealand version of the income tax concept is influenced by the usage of the term "income" in accounting practice, which, in turn, relies on the economic definition of income. The traditional accounting concept of income is built largely upon an economic definition proposed by Hicks (1946). Hicks postulated income as: "the maximum value [that a person] can consume during a week, and still expect to be as well-off at the end of the week as he was at the beginning" (p. 172). Hicks argued that capital gains should be included within the definition of income. He saw the need for a tax on capital gains, to prevent people from avoiding high levels of income tax on dividends through untaxed capital gains on stock and shares (Hicks, 1947).

It is noted that both Hicksian and Haig-Simons concepts of income refer to an individual's wealth accrual and consumption expenditure. Theoretically, Hicks's analysis focused on people's expectations while Haig-Simons emphasised people's pre-existing entitlements. Hicks' interpretation encompassed expected gains but omitted unexpected gains. On the other hand, the Haig-Simons concept of income made no distinction between expected and unexpected gains. Nonetheless, the theoretical differences tended to be narrow as accounting theorists generally ignored the expectation aspects of Hicks' definition (i.e., his ex ante notion). Whittred, Zimmer and Taylor (1996) provided an accounting analogue to the Hicksian comprehensive income concept stating "a firm's income is the maximum value which it can distribute during an accounting period and still be as well-off at the end of the period as it was at the beginning" (p. 105). An ex post notion of income is thus adopted. Under this definition of income, differences between the Hicksian and the Haig-Simons concepts of income are diminished with the slight difference being due perhaps to the inclusion of imputed income. The Haig-Simons income generally includes imputed income from non-market transactions (such as imputed rent on owner occupied housing) while the accounting Hicksian income tends to ignore that due to measurement difficulties of imputed income.

Holmes (2001) has observed that accounting theorists generally favoured the Hicksian comprehensive income concept over the Haig-Simons definition of income. He noted that accounting theorists seldom made reference to the Haig-Simons definition of income even though such a notion of income had gained wide appeal in jurisprudence and public policy literature.

Traditionally, a conservative approach to income and capital concept has been adopted in the accounting framework which recognises "realised" gains from market transactions only. Under the historical cost convention, the holding gains or "capital gains" on assets held by a business unit over an accounting period are recognised only on the occasion of the sale or other disposal of assets. Any accrued or unrealised capital gains are excluded from income.

For the last two decades, there have been some moves towards a more comprehensive measurement of an entity's income. For instance, both realised and unrealised gains and losses have to be disclosed in the Statement of Movement in Equity (previous New Zealand FRS 2: Presentation of Financial

Reports). Devonport and McNally (1996) considered that the reporting of "comprehensive income might be appropriate in some cases where the measurement system used resulted in a measure of comprehensive income" (p. 59). However, it was an incomplete version of comprehensive income as the accounting standard FRS-2 did not require the revaluation of the current value of all assets. The approach used in the modified historic cost model was criticised by Holmes (2001) as lacking "theoretical rigour because value changes were incorporated on an ad hoc basis" (p. 571).

More recently, extensive changes have been made in the accounting principles as a result of harmonisation of international accounting and disclosure standards. The International Accounting Standards Board (IASB), which sets accounting principles for international accounting practices, has adopted a comprehensive income approach and favoured inclusion of both realised and unrealised components of income. The IASB website provides a wide range of information about reporting comprehensive income such as income recognition, the realisation principle and the fair value concept. "Comprehensive income" is defined as "all recognised changes in assets and liabilities from transactions or other events except those related to transactions with owners as owners" (IASB, 2001, p. 1). The IASB rejected the notion of the "realisation principle" for profit recognition, and the Board considered that "realisation means something different in different countries". The IASB required that changes in "fair value" of assets should be recognised in the income statement. The adoption of the Board's International Financial Reporting Standards is mandatory for financial reporting in New Zealand.

In the context of New Zealand's tax system, one significant development is the alignment between taxation and accounting for financial arrangements under the International Financial Reporting Standards (IFRS). Under the Financial Arrangements Rules of the Income Tax Act 2007[3] (ITA 2007), taxpayers who adopt the New Zealand IFRS to report financial arrangements for financial accounting purposes must also adopt the same IFRS standards for tax purposes

[3] Sections EW 14 and EW 15B to EW 15I of the ITA 2007

(subject to some specific exceptions). These rules draw on the same concept as accrual accounting. With the accrual basis of accounting, the comprehensive income (which includes capital gain) from holding a financial arrangement (e.g., debt instrument) over a period is taxable as assessable income (see further discussion in section 2.2.4).

In addition to the Financial Arrangement Rules, there are a number of references to accounting concepts or the generally accepted accounting practice (GAAP) in the ITA 2007. These references are necessary in defining terms such as "income", "deductions" and "timing" (i.e., the allocation of income and deductions in particular income years) (Gordon, 2003). In general, income is allocated to the year in which it is "derived" or "realised", which is based on ordinary accounting principles. Section BD 3 of the ITA 2007 provides that all taxpayers must allocate each item of income to an income year. Past legal cases such as Farmers Trading[4], and Arthur Murray[5] have established that the accrual accounting method is regarded as the appropriate method of income recognition for persons carrying on a business[6]. Moreover, the Court[7] often relies on accounting evidence in order to determine the nature of income (i.e., to determine what is and what is not income such as capital gain).

It is noted that the determination of a tax deduction and the timing of deductibility are subject to its own specific code and concepts. Section DA 2(1) of the ITA 2007 expressly denies a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. Although the accrual accounting principle

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[4] C of IR v The Farmers' Trading Co Ltd (1989) 11 NZTC 6,007

[5] Arthur Murray (NSW) Pty Limited v C of T (Cth of A) (1965) 114 CLR 314

[6] It is noted that the accounting concept of income does not apply to non-business income as there is no imperative to match income with a particular item of expenditure. In terms of non-business income, it is generally recorded on a cash basis. More discussion of this judiciary income is given in 2.1.3.

[7] For example, in Rangatira Ltd v CIR [1997] 1 NZLR 129; (1996) 17 NZTC 12,727 (PC), the case was concerned with the taxation of capital gains on shares. The High Court utilized accounting evidence in order to determine whether the share transactions constituted a taxable activity. More discussion of the case is given in section 2.2.3.

does not apply to deduction, the Court has nonetheless adopted ordinary commercial accounting principle as one of the criteria to assist in determining whether an expenditure or loss is capital or revenue in nature. For example, in C of IR v McKenzies New Zealand Ltd[8], the Court of Appeal listed five important factors to determine the meaning of capital. These were:

(a) the need or occasion which called for the expenditure.
(b) whether the sums were made from fixed or circulating capital.
(c) whether the payments were of a once and for all nature, creating assets or advantages which were an enduring benefit.
(d) how the payment would be treated on ordinary principles of commercial accounting.
(e) whether the payments were expended on the business structure of the taxpayer or whether they were part of the process by which income was earned.

Due to the doctrine of precedent in common law, this Court of Appeal decision, which was derived from the Privy Council decision in BP Australia Ltd v C of T of the Commonwealth of Australia [1966] AC 224 (PC), is binding in New Zealand tax law.

In practice, different income approaches are being used in taxation and accounting and have created differences in accounting results and taxable income. These diversions can be generally categorised into (a) permanent differences and (b) timing differences. Permanent differences arise when an income or expenditure will never be allowable as a deduction or included in calculating assessable income for tax purposes. These items include the goodwill amortisation, provisions for doubtful debts, and capital gains and losses incurred by a business. As for timing differences, they arise when an income or expenditure is “recognised” in a period in the tax computation different from that in the financial statements. The treatment of income or the expenditure should be identical from a long-run perspective. For example, tax depreciation is calculated on statutory rates that are based on the estimated economic life (as used in accounting). An

[8] (1998) 10 NZTC 5,233

accelerated depreciation rate, which is different from that allowable for tax purposes, may be adopted for the calculation of depreciation for accounting purposes.

Understanding these differences is important in defining the terms “income” and “capital gain”. As stated above, permanent differences arise as capital gains are normally excluded for tax purposes while accounting recognises “capital gains” as income. It would also be possible for certain capital gains (such as depreciation recovered on the disposal of pooled depreciable property and unrealised increases in the value of foreign investment funds under the fair dividend rate of return method) to be treated as taxable income and differently treated in the calculation of accounting income for the same period.

Moreover, there might be instances where the differences might occur in different periods i.e., timing differences. These instances arise as certain “capital gains” are taxable as assessable income under the Income Tax Act 2007 (New Zealand Inland Revenue, 2007b). One example is the capital gains arising from the disposal of equity investments. Under the accounting system, an investment company is required to revalue its share portfolio annually to reflect the fair value of the assets. Any unrealised capital gains are included in earnings, or directly in equity (depending on the asset’s classification in accordance with accounting standards), regardless of the intention of the company. In contrast, capital gains earned by the investment company are not taxable under the Income Tax Act, provided that the taxpayer’s intention is to invest the shares to yield dividend income on a long term basis (i.e., on a capital account). However, if the company has later changed the nature of its business activities or has changed its purpose in acquiring the shares, the capital gains on the disposal of shares will become taxable under sections CB 4 and CB 5 of the ITA. There will be a timing difference between the accounting and tax perspectives as it may take some time for the taxpayer’s intention to be crystallised. This difference means certain capital gains on some of the early share transactions are able to escape from the tax net. Moreover, the timing difference is contributed by the fact that the tax is levied only upon the realisation of capital gains rather than on an accrual basis, as under the accounting system. In essence, the recognition of income for these types of capital gains is simply an issue of timing that defers the recognition of changes in wealth (or equity) relative to the moment that should be recognised under an ideal comprehensive income concept.

Interestingly, the concept of timing of income recognition is an evolving one and more complex than first appears. There is no universally applicable concept on timing in both the accounting and taxation contexts. In principle, the developments in the accounting and taxation areas are closely related to the economic definition of comprehensive income. The approaches in respect of the allocation of income to a particular period can be very different. As stated earlier, accounting has evolved from a traditional historical based accounting to a modified historic cost accounting, and more recently, to a fair value based accounting via the implementation of the IASB's comprehensive income approach. Under the IASB's definition, most gains, whether they are revenues or gains, realised or accrued, are included as "income". For taxation purposes, changes in the tax system are more on a "piecemeal basis" (Alley & James, 2005, p. 9). Although certain accrued capital gains are now included as income (such as gains from financial arrangements and the foreign investment funds), the tax system remains at a stage where income is recognised only when it is "derived" or "realised". "Capital gains" are generally not recognised as "income". The legal definition of "income" and "capital gain" is discussed in the following section.

2.1.3 Legal perspective

Under the New Zealand tax legislation, both the terms "income" and "capital gain" are not exhaustively defined. However, Part C of the Income Tax Act 2007 provides considerable guidance as to what is to be included as income for tax purposes. Part C lists a number of general categories of income, such as business income, income from property, royalties, interest, dividends, and various types of gains. There is also a "catch-all" provision in section CA 1(2) which provides that an amount is also income of a person if it is their income under ordinary concepts. An analysis of common law principles is required to interpret the meaning of ordinary concepts (Alley & Maples, 2006).

In regard to capital gain, there are many tax provisions which are specifically designed for taxing "capital gains" (even though these gains are being labelled as "income" under the legislation). For example, section CB 14 requires that certain profits made as a result of land price increases following a change of zoning are included as income. The details of the "capital gains" provisions in the ITA, where realised and unrealised capital gains are subject to income tax, will be discussed in section 2.2 below.

There are many reasons for including the "capital gains" provisions and each such provision has its own history. The most important reason for the inclusion was to prevent people from converting otherwise taxable income to tax-free capital gain. The most recent tax reforms suggested that improving the economic efficiency and equity of the tax system was also an important objective (McLeod Committee, 2001a; Stobo Committee, 2004). As regards these objectives, the Haig-Simons' concept of comprehensive income was often adopted in defining the concepts of income in the policy setting process.

Another influence in determining the legal definition of "capital gain" is the judicial concepts developed by the courts. Over the years, the courts have established several tests in determining whether a receipt is "income"[9]. These are: (a) income is something which comes in i.e., realisation; (b) income imports the notion of periodicity, recurrence and regularity, and (c) whether a particular receipt is income depends upon its quality in the hands of the recipient. Unfortunately, the courts have yet to develop a satisfactory definition of income as the case law has often produced vastly different outcomes. Hannan and Farnsworth (1946) described "income" as an illusive import which cannot be defined in precise terms to adequately meet legislative requirements. As for the judicial definition of "capital gain", Oliver (2001) commented that the concept of "capital gain" was not even recognised by the courts in the context of the New Zealand income tax law, that the term "capital gain" had no legal recognition and that it was not exempt or excluded income.

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[9] Reid v CIR (1984) 6 NZTC 61,624 61,629

Fundamentally, these judicial concepts are reflections of the classical definition of economic income offered by early political economists in the nineteenth and early twentieth centuries (Krever & Brooks, 1990; Holmes, 2008). As discussed in section 2.1.1, the Fisher's view of economic income supported the notion that income taxation should be levied on a base made up of aggregation of sources in which capital receipts are often excluded. As such, the term "capital gains" was used to describe the broad range of gains that did not fall into the judicial concept of income.

Moreover, the judiciary turned to trust law and other precedents for the definition of income (Krever & Brooks, 1990; Holmes, 2008). Traditionally, the concept of trust law followed the classical economic definition. Daunton (2004) asserted that the exclusion of capital gains from the legal income definition was based on the concept of "res" in trust law which recognised a difference between those beneficiaries entitled to receive income from property, and those beneficiaries entitled to receive the property itself (referred to as capital beneficiaries). In Eisner v Macomber 252 US 189, 206 (1919), Pitney J observed that:

> The fundamental relation of "capital" to "income" has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as reservoir supplied from springs, the latter as the outlet stream to be measured by its flow during a period of time.

The New Zealand Royal Commission on Social Policy (1988) revealed that "with hindsight it seems surprising that concepts of trust law were considered an appropriate substitute for a direct focus on economic efficiency and equity concerns in the raising of taxes" (p. 450). Due to the increasing acceptance of the comprehensive income concept in the context of New Zealand tax system, Holmes (2008) argued that the classical economic concept, which treated capital as the source and excluded any taxation on capital gain, had faded in relevance in policy setting. In particular, doubts had been raised by commentators about the potential suitability of the trust law in the tax arena.

Despite the demise of the classical economic concepts, this concept and its precedents are still the core principles of the Court in applying the common law definition of income in practice.

It is important to note that the Income Tax Act deems certain types of capital gain to be income, even though they may be of a non-income nature under the common law. In those circumstances, it is evident that economic and accounting concepts are being used to determine when revenue is derived for tax purposes. While the Act is “open ended” with respect to the derivation of revenue, it takes a much more restricted approach for the deduction of expenditure. Although economic and accounting concepts are used to determine when revenue is derived for tax purposes, the tax system simultaneously applies common law rules to carve out capital gains and the allowable deductions (Holmes, 2008). In essence, what the tax system has done borrows some of the facets of economic theory while ignoring the core of the theory (i.e., the comprehensive income). The ad hoc choice of what to keep and what to ignore in tax policy setting fails to develop a set of consistent principles in capturing the underlying economic reality. This approach has resulted in a vague notion of income with “often detailed and complex legislation” in New Zealand (Oliver, 2001).

The differential tax treatment between income and capital gain has given rise to significant ambiguity around the capital/income distinction. It should be noted that although significant efforts have been made by the courts to develop tests in distinguishing the differences between income and capital receipts, the overall results of the decisions in a vast number of cases on this subject have only suggested that at best the distinction is an “elusive concept” (NZ Master Tax Guide, 2008, p. 212). The issues surrounding the capital/income distinction will be further discussed in the next section.

2.2 Issues surrounding the capital/income distinction

As discussed in section 2.1.3, New Zealand does not have a comprehensive CGT, yet the Income Tax Act includes some items which are regarded as capital gains in the ordinary sense of gross income for tax purposes. The distinction between capital and income is vital to the interpretation and application of the Income Tax Act 2007. In certain circumstances, the legislation redefines the capital/income boundary set by case law. Most items of "gross income" are receipts which are regarded as income in the ordinary sense, for example, business income and dividends, and are found in Part C. The Act also captures a wide range of changes in the value of assets and liabilities including income from land sales, income from the disposition of personal property, and all gains by holders of debt instruments[10]. Since the Act does not define the terms "capital" and "capital gain", it is often left to the court's discretion to decide the true nature of a transaction i.e., whether it is a taxable income or tax-free capital gain.

2.2.1 Capital/income distinction

Traditionally, New Zealand has excluded realised capital gains from the determination of business income for tax purposes. Section CB 1 (or CD 3 of the 1994 Act) states that any amount derived from a business is income, but at the same time, section CB 1(2) provides that this does not apply to an amount that is of "a capital nature". This distinction means that any gain derived from the sale of capital assets is excluded from assessable income unless those assets are sold in the conduct of the taxpayer's business i.e., transferring from capital account to revenue account. In that case, the capital assets are deemed to be trading stock and any gain on disposal is taxable as ordinary income, thus placing significant pressure on the capital/income distinction.

Sometimes, the distinction between capital and income is a clear one, and a pattern of precedents which enables consistent interpretation of what constitutes capital and income can be identified. Usually a profit from a transaction is an income if the receipt is periodic and regular, while lump-sum receipts usually indicate sums of a nature of capital[11]. However, this is an indication only. The final decision will vary, depending on the facts and circumstances of the case.

[10] These specific tax provisions are discussed in sections 2.2.2 to 2.2.11 below.

[11] Reid v CIR (1985) 7 NZTC 5,176 (CA)

Prebble (1993) argued that the capital/income distinction in the judicial sense might be an artificial one. In particular, the application of the distinction in the borderline cases could be extremely difficult. Income itself is already a subjective concept in the legal context, not to mention the non recognition of "capital gain" by the courts as discussed in section 2.1.3. In fact, despite the widespread use of the term "income", "income" lacks a clear legal definition in practice (Chan, 2001). Sir Wilfrid Greene MR in IRC v British Salmson Aero Engines Ltd [1938] 2 KB 482 at 498 commented that in many cases "the spin of a coin would decide the matter almost as satisfactorily as an attempt to find reasons".

Thus, it is not easy to define exactly what capital is. Several judicial tests have emerged to identify the nature of a receipt. The definition of "capital gain" is best illustrated with examples below.

1. Receipts for the disposal of capital assets

In general, amounts received in connection with the disposal of long term income-earning assets are in the nature of capital. For example, in the case of GPO Holdings Ltd v CIR (1996) 17 NZTC 12,429 (HC), the taxpayer received a sum for the sale of the business which included a trading profit of $7.641 million derived by the business over the 5 months between the execution of a sale and purchase agreement and its settlement. It was held that all but $102,564 of the $7.641 million received on settlement was receipt of capital in relation to the purchase price of the business (capital), while the trading profits of $102,564 derived by the business over the 2 days between assignment and settlement were found to be receipt of income in the hands of the taxpayer.

2. Compensation for the loss of capital assets

Where taxpayers lose income-earning assets and receive compensation for such a loss, such receipts are usually deemed by the Court to be of a capital nature. For example, in the case of Union Steamship Co of NZ Ltd v CIR (1996) 17 NZTC 12,629 (CA), a shipping company surrendered an option to purchase three shipping vessels in return for three lump sum payments and reduction in the annual fixed hire of the ships. The Court of Appeal held that the payments were capital.

3. Compensation for the loss of profits

As a general rule, such compensation receipts are assessable in the hands of the taxpayer. These compensation payments tend to be in lieu of what would have otherwise been assessable income, and should not be confused with the previous category of compensation of a capital nature related to the loss of capital assets.

In TRA Case V8 (2001) 20 NZTC 10,092, the company concerned received an out-of-Court settlement of $270,000 for proceedings it brought against its supplier and manufacturer. The compensation was a payment for the recovery of loss of profits due to the poor performance of the defective machine (not compensation for the machine itself). The Court held that such compensation receipt was deemed to be assessable income.

4. Receipts in respect of trade tie arrangements

These receipts are interesting as their character is subject to doubt. In general, such receipts are often deemed to be of a capital nature and the arrangements are common in the oil industry, where petrol wholesalers restrict the business activities of service stations requiring them to sell their own brands exclusively. For example, in the cases of CIR v City Motor Service Ltd and CIR v Napier Motors Ltd [1969] NZLR, payments received by a retailer to improve the business premises in return for a trade tie with the petrol wholesalers were deemed to be of a capital nature.

In contrast, in the case of Birkdale Service Station Ltd v CIR (1999) 19 NZTC 15,493 (HC) and (2000) 19 NZTC 15,981 (CA), one-off inducement payments made to service station proprietors to sell a petrol wholesaler's product exclusively were held to be revenue. Under the agreements, the taxpayers were not required to use the inducement payments for capital improvement. The Court of Appeal decided that, since the taxpayers did not alter their businesses' structural nature in exchange for the inducement payment, the payments were revenue in nature.

In order to determine the nature of trade tie payments received by petrol retailers, the Inland Revenue Department (2003, pp. 16-17) followed the approach adopted in the Birkdale Service Station case and considered the following factors as relevant:

- Whether the retailer has given up anything significant in return for the tie and, in particular, whether it has made structural alterations to its overall business operation
- The length of the trade tie
- The correct accounting treatment

In summary, the aforementioned examples illustrate the distinction between income and capital gains under the tax law concepts of business income. Even though a transaction is not part of a business activity and is not taxable under section CB 1, it does not mean the proceeds of that transaction will not be subject to tax. There are several instances where the Act specifically includes certain "capital gains" as assessable income. These provisions, which encompass the capital gains of the transactions on the capital income boundary, represent a statutory in-road of a CGT. According to Casey J in discussing the application of one of these provisions in the National Distributors case (p. 6,355)[12]:

> The provision brings within the meaning of "assessable income" profits or gains which in ordinary commercial understanding would be regarded as accretions to capital. What Parliament has done by it is to impose a limited form of capital gains tax.

2.2.2 Taxation of personal property

Traditionally, gains from the sale of personal property are not income, unless they are business income. The receipts are regarded as of capital nature. Despite this, under sections CB 4 and 5 (or CD4 of the 1994 Act), the amount derived from the

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[12] CIR v National Distributors Ltd [1989] 3 NZLR 661 (CA)

sale of a personal property will be taxable if the property was acquired for the purpose of resale or the taxpayer is a dealer in property.

Shares are treated as personal property for income tax purposes. Any gain from the sale of shares can be taxable if one of these tax provisions applies. However, the courts have strictly interpreted the provisions that the tax applies to the specific scenarios described in each provision only. For instance, section CB 4 applies only to shares acquired with the dominant purpose of resale only and does not apply to shares acquired with the intention of resale. In law, purpose and intention are not one and the same. To determine whether or not a realised capital gain on the disposal of shares is regarded as assessable income, the Court will consider the nature of the taxpayer's business and his/her purpose at the time of acquisition of the property.

In Rangatira Ltd v CIR[13], the taxpayer was an unlisted public company, with its majority shareholders being a number of charitable trusts. Although shares were regularly bought and then disposed of over a period of time, the Commissioner of the Inland Revenue accepted that any share profits were of a capital nature (i.e., non taxable capital gains) as the company invested the shares on a long-term basis. However, the level of such transactions increased from 1 April 1983 and the question arose as to whether the taxpayer had changed its policy from passive investing in shares to the carrying on of a business of buying and selling shares, and whether profits from the sale of shares and long-term securities were taxable. The High Court held that these three pieces of evidence did not indicate any change in the company's policy, which required the company to invest in long term to yield sufficient dividend income for its charitable trust shareholders. However, it held that section CB 4 applied to a number of the company's share transactions on the basis that the shares were acquired for the purpose of selling or otherwise disposing of them.

It is noted that the judges are not always consistent with their approach in applying the legislation with regard to taxation of personal property. Dunbar

[13] [1997] 1 NZLR 129; (1996) 17 NZTC 12,727 (PC)

(1997) argued that the Court of Appeal had wrongly applied some of the principle used for distinguishing capital gains from income. To make the matter even more complicated, the Privy Council in the Rangatira case left the decision open by stating that “a different judge hearing the same evidence could have come to a different conclusion” (p. 67). Dunbar suggested that the court should have focused on the character of each individual asset and allocated them to the category of revenue or capital assets.

Wilkinson and Tooley (1998) considered that the partial inclusion of taxation of capital gain on disposal of shares had given rise to inequity and inefficiency. In particular, it created distortions between active investments and passive investments (Stobo Committee, 2004). The Government addressed this problem by introducing the Portfolio Investors regime and the new Foreign Investment Fund rules. This move is discussed in section 2.2.6.

2.2.3 Land taxation

Specific provisions are made in sections CB 6 to 14 of the Income Tax Act 2007 (or CD1 of the Income Tax Act 1994) to tax capital receipts arising from land transactions. These sections list several major classes of assessable income from land disposal:

- Gain on sale of land acquired with an intention of resale (s CB 6)
- Gain made by land dealers, developers and builders (ss CB 7, CB 9 to 11)
- Gain on disposal of land which had been used as a landfill but not at the time of disposal (s CB 8)
- Gains arising from major works, subdivision or development of land (s CB 12 and 13) and
- Gains arising from resource consents or change in zoning (s CB 14).

The land disposal provisions are subject to exemption. For example, for private residence, any gain on the sale of land, being a dwelling house acquired and occupied, is currently tax exempt under section CB 16 (or CD 1(3) of the ITA 1994).

The purpose of these provisions was to counter the situation whereby land developers and builders diverted all of their income into non taxable capital gain. Without these provisions, Oliver (2001) considered that developers and builders would have become “untaxed occupations” (p. 78). These provisions, however, lacked a consistent conceptual base, and, therefore, they were described by Oliver (2001) as “detailed and complex” (p. 78).

Similarly, Singleton (2003) considered that these provisions targeted a specific group of people who undertook land transactions. In this respect, the tax legislation was not neutral as other non land transactions, which gave rise to capital gains on disposal for similar reasons as those listed in CB 6 to 14 of the Income Tax Act 2007, would fall outside the existing tax net.

Moreover, Holmes (2001) found that there had been many interpretation problems with regard to taxation of personal property and land sales. It may be recalled from section 2.2.2 that section CB 4 of the Income Tax Act applies only to personal property acquired with the dominant purpose of resale only. This is contrasted with section CB 6 which covers any land acquired with an intention or purpose of resale. Considerable efforts have been made by the courts to define the subjective meaning of purpose and to distinguish it from intention. Yet, they have not developed a satisfactory solution and therefore have not always been consistent in the application of the distinction[14]. The judicial inconsistency occurs as “what is purpose for one court may be intention, motive, or objective for another” (Holmes, 2001, p. 400).

Prebble (1986b) discussed the problem of the distinction between “purpose” and “intention” by stating:

> Much of the difficulty is caused by the use of language. Judges have not hesitated to distinguish between “purpose” and “intention” as if giving these labels to the taxpayer’s various motives (to use a different word) can resolve

[14] For example, Justice Doogue in the National Distributors case explicitly rejected the application of a purpose test used in the Privy Council judgement in Holden v CIR; Menneer v CIR (1974) 1 NZTC 61,646 (PC).

> the problem. That can never be so. Ultimately, the Courts are faced with deciding whether "purpose" as used in s 65(2)(e)[15] refers to a purpose in respect of the property sold or to an underlying ultimate purpose. Semantic analysis cannot decide an essentially functional problem. (p. 32)

2.2.4 Financial arrangements rules

The financial arrangements rules (traditionally referred to as "the accrual rules") are based on the notion of accrual accounting. Under Subpart EW, all accrued gains from the holding of financial arrangements are subject to income tax. A financial arrangement is an arrangement under which a person receives money in consideration for that person, or for another person, providing money to any person: (a) at a future time; or (b) on the occurrence or non occurrence of a future event, whether or not the event occurs because notice is given or not given[16]. Section EW 3(3) provides examples of a financial arrangement, such as a debt, a debt instrument or assignment of a person's right if there is a deferral in the payment. For the purposes of the financial arrangement rules, the capital/income distinction is eliminated, as section EW 1(3)(b) requires the parties to a financial arrangement, to disregard any distinction between capital and revenue amounts. Ultimately, the financial arrangement rules are a partial accrual-basis CGT which ensures that any capital gains of financial arrangements that were not brought to account as income under common law are treated as taxable income (.

A party to a financial arrangement is required to use one of several prescribed spreading methods to calculate income and expenditure under the financial arrangement for each income year over the term of the financial arrangement[17]. The yield to maturity method[18] is the primary spreading method (provided the taxpayer is not required to use the International Financial Reporting Standards method or any of its alternatives). This approach captures all expected cash flows

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[15] The second limb of section 65(2)(e) of the Income Tax Act 1976 is equivalent to section CB 4 of the 2007 Act.

[16] Section EW 3(2) of the Income Tax Act 2007

[17] Section EW 12

[18] Section EW 16

(including unrealised capital gains) as assessable income. To illustrate, assume that Company A borrows $100,000 cash, on a 3-year, 10% non interest bearing bond from Company B. The face value of the bond is thus $133,100. Under the yield to maturity method of calculating income, the following amounts are treated as interest income of Company B in the respective years:

Year	Principal ($)	Interest income ($)	Total ($)
0			100,000
1	100,000	10,000	110,000
2	110,000	11,000	121,000
3	121,000	12,100	133,100
	Total interest	33,100	

Since no annual interest payment is paid by Company A, the taxable interest income of Company B is effectively compounded so as to give a total interest income of $33,100. Company B's taxable interest income must be spread over 3 years in a manner which makes the interest rate invariable.

Provided certain criteria are satisfied, a taxpayer may also use the market valuation method [19] as an alternative to calculate income of a financial arrangement. Under this method, income is measured as the difference between the market value of a financial arrangement at the beginning of an income year and its market value at the end of the year. Thus, this approach captures all unrealised capital gains (whether expected or unexpected).

However, these spreading methods are not applicable to "cash basis" taxpayers[20], who do not have significant investments in financial arrangements. For this type of taxpayer, a cash or realised basis is used to calculate any income of a financial arrangement.

[19] Section EW 18

[20] Section EW 54

Whether or not a taxpayer is on a cash basis, a base price adjustment is required when the taxpayer ceases to be a party to the financial arrangement[21]. This also applies to taxpayers who cease to be New Zealand residents. The base price adjustment calculation must be made for all financial arrangements in the year of maturity, disposal or remission. Such adjustment captures any income or expenditure that has not already been revealed by the spreading method or the method applied by a cash basis person. Ultimately, both cash basis holder and any person, who applies the accrual spreading methods, are subject to the same taxable income (which includes capital gains).

Since the financial arrangements rules have potentially broad implications, certain financial arrangements (i.e., excepted financial arrangements) are specifically excluded from the Financial Arrangements Rules[22]. Examples of these "excepted financial arrangements" include share capital, an option over shares, specified preference share, insurance contract, debentures with floating rates of interest and debentures issued in substitution for shares. The reasons for the exclusion of these excepted financial arrangements from the accrual based tax regime vary but the general rationale is supported on compliance, economics and equity grounds (Glazebrook, Glyn-Jones, James, & Cole, 1999).

The purpose of the financial arrangement rules was to counter tax avoidance activities which involved the manipulation of timing of recognition of income and expenditure – to maximize early allowable deduction while deferring the recognition of taxable income. Overall, Brown and McVeagh (2004) considered that the financial arrangements rules had been relatively successful in dealing with the problems created by financial instruments as the rules had remained unchanged since its introduction.

It is noted that New Zealand is one of the few OECD countries (the other is Australia) in applying a comprehensive, accrual capital gains taxation to financial arrangements such as corporate bonds. In contrast, other OECD countries

[21] Section EW 28 to EW 30

[22] Section EW 5

generally tax the capital gains on a realisation basis under CGT or specific income tax regimes (more discussion in section 2.5.1).

However, Holmes (2001) revealed that there were tax anomalies created by the exclusion of the excepted financial arrangements, for example, share equity and preference shares. The debt-equity distinction was often blurred and it was common for "hybrid financial instruments" (such as preference shares, convertible notes and floating rate debentures) to have characteristics of both debt and equity (p. 413). He argued that the rationale for taxing accrual gains of financial arrangements should be equally applicable to gains derived from the disposal or holding of equity investments. Therefore, equity instruments should be captured under the foundation concept of income. Moreover, he considered that there was no valid conceptual reason for providing different treatment to cash basis holders. In his opinion, the rationale for the concession was simply an administrative one and it represented "the tension between the canons of equity and neutrality and the canon of administrative efficiency in the design of the tax system" (p. 418).

Singleton (2003) described the coverage of financial arrangements as "very broad" in that it potentially included any transaction that involved "deferral of the giving of consideration" (p. 44). Moreover, the regime was not neutral as certain taxpayers, such as households and non dealers were unable to automatically deduct a realised or unrealised loss due to "the credit downgrade of a debt instrument" (p. 44).

2.2.5 Controlled foreign company regime

The Act includes specific tax provisions which deem overseas income (including capital gains) derived by offshore companies and similar entities as taxable income. It imposes tax on income sourced through foreign activities by using several methods. These methods apportion the attributable taxable income (or loss) to the taxpayer by determining the interest that the New Zealand resident holds in controlled foreign companies (CFC). Under the CFC regime, a foreign company is a controlled foreign company if it meets the "control" criteria under section EX 1 (or CG 4(1) of the ITA 1994). In some circumstances, the effect of such a regime can be the taxation of accrued capital gains on all foreign portfolio equity investments unless the companies are resident in one of the "grey list" countries[23].

Major reform has been undertaken by the Government to develop a new method of imposing tax on income sourced through CFCs. One problem with the previous CFC regime is that it failed to distinguish between active and passive investments (McLeod Committee, 2001a; Dunbar, 2006). In December 2006, the Government released a discussion document which proposed reforms to the international taxation rules by providing an exemption for offshore active business (New Zealand Inland Revenue, 2006). The purpose of the reforms was stated as "to help retain dynamic companies in New Zealand" (paragraph 1.14).

In October 2007, the Government released a further issue paper which outlined the design of the new CFC rules (New Zealand Inland Revenue, 2007b). The core features of the proposal are:

1. to implement an active income exemption for CFCs which have passive income of less than 5% of their total gross income, while passive income of CFCs will continue to be taxed in New Zealand
2. to exempt dividends received from CFCs (subject to certain conditions and limitations)
3. to remove the "grey list exemption" other than for Australia
4. to repeal the conduit regime and
5. to include new base company rules and extend the existing thin capitalisation rules to all New Zealand companies with offshore operations.

Draft legislation was introduced in June 2008 with the proposed application date of the new CFC rules starting from the 2009/10 income year. However, due to its complexity and high compliance costs, the tax bill is subject to further

[23] The countries included in the 'grey list' are Australia, Canada, Federal Republic of Germany, Japan, Norway, the United Kingdom of Great Britain and Northern Ireland, United States of America and, from 2006/07 income year, Spain.

amendments and the application date is deferred for the 2009-10 income year only for taxpayers who have balance dates on or after 30 June. For all other taxpayers, the application date would be the 2010-11 income year (Stewart, 2009).

Deloitte (2008) described some of the proposed changes to the CFC regime as "incredibly complex". It considered that the proposal would place significant compliance costs on the taxpayers in applying the new rules. It recommended further simplification of the proposed rules and suggested reconsideration of the key issues, such as the removal of the grey list and the introduction of the interest allocation rules.

2.2.6 Foreign investment fund

For interest held in non-controlled foreign entities, the foreign investment fund regime (FIF) applies. A foreign investment fund is any foreign interest (section EX 28 and 29 or section CG 15(1) of the ITA 1994) held in an overseas entity with a limited number of exemptions. New FIF rules that came into effect on 1 April 2007 introduced two new methods of calculating FIF income i.e., the fair dividend rate of return (FDR) method and the cost method. In total, there are six methods for calculating FIF income or losses. However, taxpayers are restricted to use of a particular method(s) according to their situations and the type of investment involved. For most taxpayers, the FDR method is the default method for calculating FIF income.

Under the FDR method, taxpayers are taxed on a deemed rate of 5% of the opening market value of an investment of a foreign company. The 5% is also subject to the foreign exchange fluctuations. Individual taxpayers and family trusts can elect to use the comparative value method (which taxes unrealised capital gains) if their actual return (i.e., unrealised capital gains plus dividends) is less than 5%. No tax will be payable if they are making a loss. However, this option is not available to other taxpayers such as companies.

The implementation issue of the FIF rules, and in particular the FDR method, is controversial and has been subject to fierce criticism[24]. Despite the controversy, the FIF regime is recognised as an important instrument to achieve the economic goal of the Government such as encouraging saving. For example, the Retirement Commission (2007), in a major review of the retirement income policies, stated that "new distortions have been deliberately introduced to make saving for retirement, especially in KiwiSaver, attractive. All these changes have made the tax system more complicated. For some savers, saving decisions will have to take into account a new and more complex set of tax issues" (p. 80).

Irrespective of the advantages and disadvantages of FDR, Mersi (2007) considered that, the FIF rules under the method provided better neutrality in investment decisions from a tax perspective as they uniformly taxed share investments across different countries.

Although it is yet to be seen what impact the new FIF rules will have on the tax system in practice, at the conceptual level the new regime represents "a fundamental change" in the way in which foreign investments are taxed (Alley et al., 2008) It is stated that:

> The new FIF rules shift away from comprehensively taxing unrealised gains (based on Haig-Simons theoretical concept of economic income) and move towards taxing a more modest deemed return that is more likely to approximate the amount of income arising from a comparable domestic or Australian investment held on capital account. (p. 695)

2.2.7 Corporate distributions of capital gains to shareholders

Section CD 1 regards dividend derived by a person as income of the person. The dividend definition[25] is very broad and covers a wide range of transactions where

[24] For discussions about the advantages and disadvantages of the Fair Dividend Rate method, see Dixon (2003), Prebble (2006) at p. 157-164 and Alley et al. (2008) at p. 695-697.

[25] Sections CD 4 to CD 21

value might be transferred to a shareholder with the exclusions [26] relating primarily to return of subscribed capital and capital gains on liquidation. In the absence of any exemption, this ruling means that capital gains are effectively taxed at the shareholder level when the gains realised at the corporate level are distributed in the form of dividends. Since capital gains are generally excluded from the income tax at the corporate level, no imputation credit is attached to the distributions of those gains. Therefore, at the shareholder level, the distributions of capital gains are treated as the shareholders' dividend income and are liable to personal income tax.

Prebble (1986a) revealed that there was some injustice created by the exclusions such as the distributions of capital gains on liquidation. The problem occurred when there was more than one major shareholder in a company. While it might be advantageous for one shareholder (e.g., a retired shareholder) to wind up the business, it might not be the case for the other shareholders as they would face a large accrued tax liability in respect of inventory if the assets of the company were liquidated.

It is noted that one reason why New Zealand opposes the introduction of a comprehensive CGT is that the current tax system has already covered "a significant amount of capital gains" because of the tax treatment of corporate distributions of capital gains. On revenue consideration, this tends to "reduce the amount of additional tax revenue that could be expected from the introduction of a CGT" (OECD, 2006b, p. 32).

2.2.8 Receipts relating to contracts involving lease agreements

Specific provisions have been made in the Income Tax Act 2007 to tax capital receipts arising from lease agreements. These provisions are applicable to any capital gains derived from the sale of lease agreements on the use of lands (section CC 1) and the disposal of leased asset such as plant, machinery, motor vehicles and equipment (sections CG 7 and FA 5).

[26] Sections CD 22 to CD 36

Under section CC 1, certain payments for the goodwill or premiums (i.e., capital gains) received on the grant of a lease on land (or in any similar manner) are taxable as assessable income of a lessee. This ruling applies to premium or goodwill received on the grant of a sublease by the lessee. However, if the lessee sells or assigns the lease outright, the sale proceeds are deemed to be of a capital nature and, therefore, not taxable.

For other leased assets (such as plant and equipment), capital gains on disposal of these assets by a lessee are partially taxable to the extent of the lesser of (a) capital gain on the disposal and (b) the total rent deductions that have been claimed for the property[27]. The purpose is to "negate the benefit of the deductibility of lease payments when those payments are subsequently recouped by acquisition and resale of the asset at a profit" (NZ Master Tax Guide, 2009, p. 272). To illustrate this point, assume that Company A leases a truck for 4 years at an annual rental of $5,000. At the end of the lease period, the company acquires the truck for $15,000 and sells it for $25,000. The capital gain is thus $10,000. The following amounts are treated as income of Company A:

The lesser of:		
(i) Profit on the trade-in (i.e. capital gain)	$10,000	
Or (ii) Previous lease deductions ($5,000 x 4)	$20,000	
Gross income of Company A		$10,000

(Source: NZ Master Tax Guide, 2009, p. 272)

It is noted that tax planning opportunities can arise through the use of lease inducement payments (Committee of Experts on Tax Compliance, 1998). In general, lump sum inducement payments for entering into a lease agreement, i.e., rent-free or free fit-outs, etc., are usually deemed to be of a capital nature.

[27] Section CG 7

However, this approach has been brought into doubt by several Australian cases[28]. As with all other areas concerning the distinction between capital and income, each case must be treated on its individual merits.

In CIR v Wattie [1999] 1 NZLR 529; (1998) 18 NZTC 13,991 (PC), the taxpayer received a lump sum inducement payment for entering into a lease agreement. In addition to the lease, the firm entered into a collateral deed which provided a number of incentives, such as a lump sum inducement payment for fit-outs of the floors and a monthly rent subsidy. The purpose of the payment was to attract the taxpayer into a long-term lease. The High Court held that the receipt was of a revenue nature. The lump sum inducement was deemed to be a form of rent subsidy and represented assessable income in the hands of the taxpayer. The taxpayer objected to the decision and appealed to the Court of Appeal.

The Court of Appeal held that the payment was not a form of rent subsidy, and, therefore, not assessable income and that payment was a capital item as it was not a part of the profit arising from the taxpayer's business as an accounting firm. The Commissioner appealed to the Privy Council.

Eventually, the Privy Council rejected the Commissioner's appeal and confirmed that the inducement payment was capital in nature and that the payment was considered to be "a negative premium" which should be classified as capital. The Privy Council also rejected the Commissioner's alternative argument that the payment was a gain from a profit making venture (based on an Australian High Court decision in Myer Emporium).

The Committee of Experts on Tax Compliance (1998) recommended the taxation of capital gains derived from lease inducement payments as the tax exemption for those inducement payments would pose a significant risk to the current tax base. It was also revealed that taxpayers could divert otherwise taxable income into non-taxable capital receipts. At paragraph 3.9, the committee stated that:

[28] FC of T v Cooling 90 ATC 4472 and Selleck v FC of T 96 ATC 4903.

> As with services-related payments in restraint, the tax-free status of lease inducement payments poses a risk to the tax base. Accepting that lease inducement payments would be deductible to a commercial lessor, as in Wattie, there is an incentive for parties to leasing contracts to arbitrage the tax cash value of non-assessable but deductible lease inducement payments. This arbitrage opportunity means that the apportionment of receipts between different but readily substitutable elements, for example, between inducement payment and rent, can be highly sensitive to tax considerations.

2.2.9 Capital gains on disposal of certain depreciable property

In general, capital gains on disposal of depreciable property (i.e., depreciation recovery income) are partially taxable only to the extent of the lesser of (a) the amount by which the sale proceeds exceed the tax value and (b) the total depreciation deductions that have been claimed for the property[29]. However, there are exceptions to this general rule. Under section EE 52, taxpayers are liable to pay tax on any capital gains[30] realised in their depreciable property if the property is damaged (but not lost, stolen or irreparably damaged) and the taxpayer receives insurance, indemnity or compensation payments in relation to the damaged property.

For illustration purposes, assume that Company A receives insurance proceeds of $9,000 for the damage of its depreciable property in a flood. Before the accident, the property had an adjusted tax value of $5,000. Company A spends $2,000 to repair the property. The amounts are treated as income of Company A. The working is shown in next page.

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[29] Section EE 48(1)

[30] Capital gains (i.e. depreciation recovery income) are computed as the insurance proceeds less cost of repair and less the adjusted tax value before the damage.

Adjusted tax value before flood		$5,000
Compensation received	$9,000	
Cost of repairs	$2,000	
Excess		$7,000
Depreciation recovery income (Negative adjusted tax value)		2,000

(Source: Alley et al., 2008, p. 358)

The general rule for depreciation recovery income in section EE 48(1) does not apply to property depreciated under the pool method of depreciation. The intention of the pool method is to reduce compliance costs for taxpayers so that taxpayers are allowed to group together low-value assets ($2,000 or less each) in a pool and depreciate them as if they were a single asset. Despite its intention, capital gains on the sale of pooled assets are fully taxable as assessable income under section EE 22(5). As such, Alley et al. (2008) advised that for tax planning purposes the pool method might not be suitable for assets that were likely to be sold at more than the original cost.

2.2.10 Restrictive covenant and exit inducement payments

Restrictive covenant payments are regarded as taxable income under section CE 9. Such contracts are common in employment situations where a senior partner or executive of a firm leaves his or her position within an organisation. Section CE 9 applies when a person gives an undertaking that restricts, or is intended to restrict, his or her ability to perform services as an employee, office holder, or independent contractor.

Similarly, any exit inducement payments are also deemed to be taxable income. Under section CE 10, an amount is deemed to be an income of a person if he or she derives it for: (a) the loss of a vocation; (b) the loss of a position; (c) leaving a position, or (d) the loss of status.

Before the enactment of the above provisions, these payments, particularly for the compensation for humiliation on redundancy, were considered to be of capital nature. As a result, New Zealand employers tended to ensure “the redundant staff had been subject to increasing levels of humiliation” (Oliver, 2001, p. 83). Singleton (2003) argued that these provisions lacked a conceptual basis for taxing these types of transactions and that the purpose for the provisions was simply to provide revenue to the Government.

2.2.11 Other tax provisions related to CGT

The aforementioned sections have examined the main tax provisions that include capital gains as assessable income. There are many other specific provisions in the Income Tax Act where capital gains are subject to income tax. These include (but are not limited to):

- Gains by group companies,
- Certain distributions to beneficiaries of foreign and non complying trusts, and
- Building society prizes (unexpected gains).

Gains by group companies

Capital gains derived by a member company of a wholly-owned group of companies can be taxable under section CV 1 of the Income Tax Act 2007. This section lifts the corporate veil and deems all members of the group of companies to be a single company for tax purposes. For example, a wholly-owned subsidiary may hold an investment on capital account and any capital gains on disposal of the investment is tax free. However, upon lifting the corporate veil, the subsidiary company may become liable for income tax if it is found that the subsidiary company is formed to hold an investment of a kind that its parent company holds on revenue account.

Certain distributions to beneficiaries of foreign and non-complying trusts

Distributions of capital gains from a trust (i.e., a complying trust) are generally tax free in the hands of a beneficiary. However, certain distributions of foreign sourced capital gains of foreign trusts and non complying trusts to New Zealand resident beneficiaries are taxable under section HC 15. More specifically, all capital gains, whether realised or unrealised, are regarded as taxable distribution for non complying trusts while only capital gains derived from transactions with associated persons are taxable in the case of a foreign trust (Brown, 2005).

Building society prizes (unexpected gains)

Under section CC 6, any ballot prizes arising from building society bonus balloting shares are treated as assessable income in the hands of the recipient (e.g., prize winner). The prizes, which can be taken in the form of cash or advances, are unexpected gains of the prize winner and such windfall gains are taxable in full. In contrast, if a building society holds a competition, which is not related to bonus balloting shares within section CC 6, prizes received in relation to that competition will be exempt from tax.

2.2.12 Summary

This section has generally addressed the issues surrounding the capital/income distinction by providing an overview of the major provisions of the Income Tax Act that tax potential capital gains. The summary is illustrated in Table 2.1 below.

Table 2.1 Summary of the major provisions of the Income Tax Act that tax potential capital gains

"Income" under the Income Tax Act	Details	Section (Income Tax Act 2007)
Business income	• Receipts for the disposal of capital assets • Compensation for the loss of capital assets • Compensation for the loss of profits • Receipts in respect of trade tie arrangements	CB1

"Income" under the Income Tax Act	Details	Section (Income Tax Act 2007)
	• Receipts relating to contracts involving lease inducement payments	
Gains from the sale of personal property (e.g., public listed New Zealand company shares)	Capital gains will be taxable if: • The property was acquired for the purpose of resale; or • The taxpayer is a dealer in property	CB 4 and 5
Receipts arising from land transactions	Capital gains will be taxable if: • The land was acquired with an intention of resale; • The gain is made by land dealers, developers and builders; • The land has been used as a landfill but not at the time of disposal; • The gains derived from major works, subdivision or development of land; or • The gains derived from resource consents or change in zoning	CB 6 to 14
Income from financial arrangements (e.g., debt instrument)	For cash basis taxpayers: • Capital gains are taxed on a realised basis For non cash basis taxpayers: • Capital gains are taxed on an accrual basis	Subpart EW
Income from controlled foreign company (Subject to amendments)	Overseas income (including capital gains) derived by offshore companies which are controlled by New Zealand residents is subject to income tax.	EX 1
Income from foreign investment	Capital gains on foreign investment funds are taxable on an accrual basis.	EX 28 and 29

"Income" under the Income Tax Act	Details	Section (Income Tax Act 2007)
fund (e.g. public listed company shares in the UK)	The FIF income is calculated using the fair dividend rate of return method.	
Dividend income	Corporate distributions of capital gains to shareholders are taxable.	CD 1
Receipts relating to lease agreements	Capital gains derived from the sale of lease agreements on the use of lands and the disposal of leased asset (such as plant, machinery, motor vehicles and equipment) are taxable.	CC 1, CG 7 and FA 5
Depreciation recovery income	Capital gains on disposal of depreciable property can be clawed back. Full capital gains tax applies if the property is damaged and the taxpayer receives compensation payments in relation to the damaged property. Also any capital gains on the sale of pooled assets are taxable.	EE 48(1), EE 52 and EE 22(5)
Employment income	Restrictive covenant and exit inducement payments are deemed to be income.	CE 9
Other specific gains	The following gains are subject to income tax: • Gains by group companies, • Certain distributions to beneficiaries of foreign and non-complying trusts, and • Building society prizes (unexpected gains)	CV 1, HC 15 and CC 6

It is noted that one major problem is that the capital/income distinction is blurred by the fact that certain types of gains that would normally be regarded as capital gain are deemed to be income. For simple cases, the distinction might be a clear one, but it can be extremely difficult in other border-line cases.

Another problem is the extent to which capital gains are taxed. Taxation extent is heavily dependent on the types of assets under consideration. For example, a mum-and-dad investor will pay tax for realised capital gains on disposal of shares if the shares are acquired with the "dominant" purpose of resale. This situation is contrasted with the foreign investment fund regime which taxes a deemed rate of return (or unrealised capital gain), irrespective of the investor's intention.

Moreover, these tax provisions are designed to be very specific. Such partial inclusion of capital gains by no means constitutes a comprehensive CGT. The problem here is that it provides an incentive for taxpayers to convert an income into a receipt of capital nature to avoid liability (unless the Inland Revenue views the transaction as part of a tax avoidance scheme). As a result, it is left to the Court's discretion to decide whether or not the transactions are capital in nature.

2.3 Development of the taxation of capital gains in New Zealand

New Zealand has never had a structured approach to developing policy in regard to taxation of capital gains. There have been a number of major government-sponsored enquiries relating to the issues of taxing capital gains. Other major contributors to the tax policy debate include the Treasury and the Inland Revenue, as well as the private sector, professional bodies, lobby groups, and the media.

Since 1967, there has been substantial discussion in newspapers and academic literature about taxation of capital gains in New Zealand. Most of the arguments put forward by researchers are either based on their professional opinions (such as legal analysis and/or critical analysis), or rely on findings of overseas empirical studies. It is not uncommon for an author who favours a CGT to be opposed by others drawing on the same tax principles (For an example, see Hide (2001.) and Morgan (2001)). Even different Government tax committees have expressed different opinions based on the same tax evaluation criterion. For example, the

Ross Committee (1967) considered that the main reason for taxing capital gains was largely motivated by notions of equity. Fifteen years later, the McCaw Committee (1982) accepted the equity arguments for a CGT "in principle", but it questioned the introduction of a CGT in a period of high inflation and considered that the taxation of nominal capital gains would "probably bring more inequities than it would cure" (more discussion in later section).

The lack of a consistent theoretical framework in taxing capital gains, coupled with the fact that there is no comprehensive CGT in New Zealand, reflects the complexity of the issues. But to the greater extent, this deficiency creates uncertainty on the generalisation (or transferability) of inferences drawn by overseas studies with the New Zealand context, and undermines the actual economic impact of a CGT to New Zealand as a whole. It is noted that the arguments for and against taxing capital gains have been reviewed extensively in the literature[31]. This stimulates fierce debates and raises public awareness on the tax issues of capital gains taxation.

This section will first provide an overview of the development of capital gains taxation in New Zealand by looking at previous major Government reports. It will examine the arguments of each of the reports used both for and against a CGT, in chronological order. The issues surrounding the cases for and against taxing comprehensive capital gains in New Zealand are then summarised at the end of this section.

2.3.1 Pre-1967 Ross Committee Report

The question of capital gains taxation was barely considered at an official level prior to the publication of the Report of the Taxation Review Committee (the Ross Committee) in 1967. Traditionally, the tax structure in New Zealand was based on the British tax system, which primarily utilised the source concept of

[31] Krever and Brooks (1990) provided ample discussion about the reasons for and against a CGT. In their work, the case for taxing comprehensive capital gains was explained in terms of the traditional tax criteria (i.e. equity, efficiency and simplicity) and the public expenditure analysis.

income for the taxation of all income (Colwyn Committee, 1920). As discussed in section 2.1, this concept, which originated in Great Britain, reflected the classical definition of economic income provided by early political economists in the nineteenth and early twentieth centuries (Krever & Brooks, 1990). The fundamental principle was that capital gains should not be made liable to tax unless they constituted a regular source of profit (Stopforth, 2004).

Interestingly, despite strong attachment to the common law of England, New Zealand's first income tax act, the Land and Income Tax Act 1891, taxed capital gains derived from the realisation of assets. This part of tax legislation on capital gains taxation, however, proved to be short-lived and was repealed 8 years after its introduction (Goldsmith, 2008).

Holmes (2008) considered that the problem with the part of the legislation relating to capital gains taxation was that New Zealand income tax law closely followed English law, and that there was no English precedent in 1891 for taxing capital gains. Under the English law, capital gains were not included in the judicial concept of income, and hence no tax was levied on capital gains in New Zealand.

In the period 1911 to 1965, many industrialised countries such as the United States began taxing capital gains. The CGT in these countries is justified on the Haig-Simons' comprehensive income concept that capital gains are a part of capital income, and, therefore, are taxable even if the source rule is followed (Wells, 1949). The United Kingdom was behind many developed countries in introducing a CGT. Nonetheless, the tax was introduced in the UK in 1965. This is one of the areas where the New Zealand tax system diverges from its British counterpart.

2.3.2 The Ross Committee Report

The Report of the New Zealand Taxation Review Committee (the Ross Committee) provided detailed analysis on the taxation of capital gains in New Zealand (Ross Committee, 1967). With some reservations, the Committee cautiously supported the taxing of realisation-based CGT on equity grounds. It

cited the Canadian Royal Commission's (1967) view by stating "it is what you get, not how you get it, that should count for tax purposes" (p. 50).
The Committee also considered that there was the problem of tax avoidance as taxpayers would "arrange their affairs that would normally be taxable income" by converting such taxable income into non taxable capital gain. This contravened the horizontal equity as "the erosion of the tax base threw a heavy burden on those taxpayers who, by reason of the source of their income, are not able to avoid tax in this way" (p. 405). Moreover, the Committee observed that "the absence of a CGT would encourage the holding of assets for speculative purposes rather than for produce purposes" (pp. 405 -406).

Although there was strong justification for taxing comprehensive realisation-based CGT, the Committee was aware of the "quite formidable difficulties of definition and administration" (p. 111). The definition problem was related to the identification of the categories of assets which should be subject to CGT. It observed that some assets such as trading stock and private residence must be exempt and that the administration problem was associated with the computation of the capital gains. The Committee further stated that "the mechanics of introducing the tax would not be simple" as "all assets would have to be valued as at a specified date" and the system would be "entirely different from existing income tax" (p. 409). In computing the capital gains, care must also be taken to distinguish between "illusory gain" and "real gain" in a period of inflation. Similarly, capital losses could occur especially in times of deflation (falling prices). Then again care should be taken to ensure "such losses to be carried forward and set off against future capital gains" (pp. 406-407).

Lastly, the committee was also cautious about the low revenue yield of a CGT and its disincentive effects on risk taking and growth investment, as it stated that "the revenue yield would probably be low and would vary from year to year" (pp. 406-407). It was these reasons that prompted the Ross Committee's decision to hold further consultation before a CGT was introduced.

However, in the context of designing a CGT model, it is noted that the Committee briefly considered the possible design features of a CGT (pp. 407-408). These included the idea that:

- only net realised capital gains should be taxed;
- unrealised capital gains should not be taxed except assets deemed to be realised on the death of a taxpayer;
- all assets should be subject to CGT, except trading stock, principal residence of an individual taxpayer and his/her chattels up to certain value. Also special treatment should be provided for other assets such as works of art;
- the tax should apply to all assets owned by New Zealand residents (whether companies or individuals) both inside and outside New Zealand and to assets within New Zealand owned by persons resident outside New Zealand;
- corporations (both public and private), non incorporated bodies, individuals, and trustees should all be treated on the same basis;
- the rate to be levied on realised capital gains should be 35% in respect of an asset sold within 1 year of acquisition and thereafter 30% reduced by 2% for each complete year for which the asset has been owned by the taxpayer after the first year, until a minimum rate of 10% is reached;
- realised capital losses should be allowed to be deducted from current and future capital gains;
- a date should be fixed for the commencement of the tax and all assets valued at that date. Tax should be levied on realised gains made thereafter, and using that date as the base, such values or the cost price of assets acquired after that date. Also there should be a clause with appropriate right of objection for a relief from hardship; and
- a separate CGT Act is required.

2.3.3 The McCaw Committee Report

On equity grounds, the McCaw Committee (1982) accepted, in principle, that "there is no reason why capital gains (whether made by a business or a private individual) should not be taxed" as "such gains increase taxable capacity in just the same way as does a gain on income account" (paragraph 10.22). Therefore, the failure to tax real capital gains would be inequitable. It also found that the lack of a CGT in New Zealand provided "an incentive for funds to be diverted from productive activities to unproductive investments offering prospects of capital appreciation" (paragraph 10.22).

The McCaw Committee, however, considered two problems: (i) the low revenue yield of a CGT and (ii) the problems of taxing nominal gains in the period of high inflation. In particular, it questioned the importance of equity of introducing a CGT when these two problems were taken into consideration. First, a CGT would not produce significant revenue. It recognised that "there remains a question of equity", but it considered that "introducing substantial complexity for little revenue is not justified" (paragraph 10.25). Second, taxing nominal gains in a period of high inflation would be wrong in principle. It stated that "the introduction of a CGT in a period of high inflation would probably bring more inequities than it would cure, unless the effects of inflation were also taken into account" (paragraph 10.26). In particular, it noted that despite the inequity for taxing nominal gains, "many countries do tax nominal gains", and despite the fact that the rates of inflation in such countries had increased to a higher level, the revenue from CGT in those countries remained low, even though nominal gains were taxed (paragraph 10.27).

Before drawing up its conclusion, the McCaw Committee first discussed the adequacy of the tax treatments to the profits for the disposal of certain categories of assets that were normally subject to a CGT in other countries. In particular, it considered the issues in the context of (i) company shares and (ii) land[32].

For gains from disposal of company shares, it found that the aggregate real capital gains on equity investments "have been negative over the twenty year period". Moreover, for investors who were able to profit from such a bear market, they could potentially defer realisation of a gain and neutralised it by realising capital

[32] The McCaw Committee also considered the tax implication on borrowing gains. The problem has been dealt with by the introduction of the Accrual regime.

losses on other assets. Therefore, the Committee argued that "it is presumably this sort of arrangement that makes the revenue from the tax (CGT) so small in countries which have adopted it" (paragraph 10.29).

For gains on land, the Committee looked at the tax treatment in respect of (a) rural land, (b) residential properties and (c) the sale of land on revenue account. It observed that some potential existed for the realisation of significant capital gains on the sale of rural lands as the price of rural property had increased significantly at that time. However, it considered that the increase in values apparent at the time was directly related to the tax incentive then available, and "it would be inappropriate to tax benefits accruing as to do so would undermine the benefit originally offered" (paragraph 10.31). Rather than bringing in a CGT, a better approach was to change the incentive to bring it more in line with the intention of the incentive. Similarly, the Committee also observed there were substantial gains on residential properties. However, it argued that since the "principal residence of a taxpayer is usually exempted from the impost of the tax, with the result that the CGT revenue that would have been derived from this source is probably small". Also, it considered that the real gain on the sale of a principal residence "is to some extent illusory" as the vendor generally needed "to replace the property with one of a comparable standard" (paragraph 10.32). Lastly, the committee considered that section 67 of the Income Tax Act 1976 (which is equivalent to section CB 6 to 15 of the Income Tax Act 2007) already provided "a wide code for the assessment of profits made on the sale of land". Section 67 not only covered profits from revenue transactions, but also included "capital gains" such as certain profits made as a result of land price increases following a change of zoning. Therefore, it considered that "the breadth of this provision further reduces the need for a specific CGT" (paragraph 10.33).

In conclusion, the McCaw Committee opposed the introduction of a CGT using grounds of "equity" to defend for its recommendation. It stated that:

> The Task Force is not convinced of the need for a separate capital gains tax, and does not propose its introduction, even though capital gains are being made by some which should in principle be taxed. The adoption of the suggestions concerning determination of business

income would substantially meet equity requirements (paragraph 10.36).

It is interesting to note that the equity requirement in the McCaw Committee is quite different to the criterion used by the Ross Committee. The McCaw approach is more pragmatic in that the notions of equity can be quantified by monetary cost, while the Ross approach is more concerned with the ideology of horizontal and vertical equity.

2.3.4 The Valabh Committee Report

The Consultative Document on the Taxation of Income from Capital (Valabh Committee, 1989) outlined the problems arising from the exemptions of capital gains relating to: 1) income from profits on the disposal of land, shares and other "investment" assets; 2) income from goodwill payments and other profits from the sale of a business of activity; and 3) other income on capital account, e.g., payments under restrictive covenants. The Valabh Committee considered that the market was distorted due to the presence of such exemptions. People would be encouraged to invest into tax-exempt capital intensive investments. Also there was more incentive at that time to invest in "goodwill" and brand names than in more productive activities.

The Valabh Committee supported the introduction of a CGT. It identified several reasons for taxing comprehensive capital gains. Firstly, the notion of horizontal equity meant that taxpayers deriving income from capital gains should bear the same tax burden as those earning taxable ordinary income. Secondly, on the efficiency and neutrality grounds, the tax treatment of investments which yielded capital gains would be aligned with the treatment of other investments. Thirdly, it was argued that a CGT would raise more revenue, and lead to reduction in the tax rates of income taxes and other taxes as well. Lastly, a CGT would protect the income tax base by reducing the taxpayers' incentives to convert otherwise taxable income into non taxable capital gains.

The Committee proposed adopting a full CGT with indexation (adjustment for inflation) which applied to all forms of income from capital. Under the proposals, capital gains would be assessed as ordinary income under normal income tax rules, instead of a separate CGT. It recommended a realisation-based CGT which was considered to be more practical than an accrual based CGT. It believed that the administrative problems of requiring taxpayers to provide market valuation of assets, particularly for those which were difficult to value, would be more complicated under an accrual system. However, it recommended a continued investigation of an accrual approach because of the lock-in problem of a realisation-based system.

In terms of asset coverage of the proposed CGT, most capital gains (including gains on disposal of intangible property) would be captured under the proposals. Only a narrow range of personal assets would be exempt (with conditions). In this respect, the Committee discussed special tax treatments of three different types of personal assets, namely, (1) residence, (2) household durables, and (3) jewellery, fine art and collectables. Regarding residence, the Committee was well-aware that real gains (i.e., true gains not including any inflationary element) in real estate had been negligible (only 0.7% p.a.) over the period 1962 to 1988, and most home owners were unused to keeping detailed records for tax purposes. Despite this, it recommended a full taxation of capital gains on the sale of a home, and opposed a complete exemption of housing. A full CGT on housing would prevent high income taxpayers avoiding the tax by increasing their investment in houses. To mitigate the administrative problems, an indexed standard annual allowance (such as $4,000) would be allowed to be added to the acquisition cost. Alternatively, a house owner could claim the actual amount of expenditure incurred on capital improvements if he/she provided sufficient records to justify the amount. As regards household durables, income or losses on the disposal of cars, boats and other household durables would be exempt unless the assets were acquired with an expectation to appreciate. Lastly, income or loss in respect of jewellery, fine art and collectables were included for CGT purposes as these assets would normally appreciate in value. Interest expense incurred in relation to the purchase of these assets would be deductible. Also a small exemption threshold was provided for administrative reasons.

In general, the Committee considered a CGT liability would occur when the gain on the disposal of an asset was realised by a taxpayer. It also deemed a realisation to take place on death, gifting, where there was an involuntary transfer of ownership, or where an asset was leased on a long-term basis. Moreover, all New Zealand residents would be liable to tax on gains from the disposal of any asset irrespective of where the income was derived, while non residents would pay New Zealand tax on gains from the disposal of assets that had a New Zealand source. In essence, the committee focused on the transfer of rights to enjoy an asset, rather than the transfer of ownership. The only rollover (non recognition) relief available was the transfer within a wholly owned group of companies. There was very limited rollover relief in the proposal for corporate restructuring when compared with the position in most other countries with a CGT (McLeod & Oliver, 1990).

In calculating the initial acquisition cost of a property, a deemed market valuation applied to assets acquired before the implementation date as a transitional measure. Where the market value was not readily available, a "time apportionment method" applied – a determination of the deemed acquisition cost by prorating the difference between the actual acquisition cost of the property and its sale price over the period that the property had been held. This method assumed that any income or loss realised on the sale of an asset had accrued to the owner on a straight line basis over the entire period in which the asset had been owned.

The Committee recommended that capital losses would need to be ring-fenced as an anti avoidance measure, so that losses on the disposal of any form of property could be deductible only against gains from the disposal of property. Also emigration would give rise to a taxable disposal so that any accrued, but unrealised, capital gains would be liable for CGT purposes.

Contrary to the Valabh Committee, the Government quickly announced, at the time the report was released, that family homes would not be taxed. However, at that stage, the proposal would apply to other classes of homes, such as rental accommodation and holiday homes. Three months later, the Labour government in its March 1990 economic statement announced that these proposals were "off the agenda" due to strong public opposition. Since then, the subsequent National Government and Labour Governments have been opposed to introducing a capital gains tax. Political factors have, therefore, added considerable influences as to whether comprehensive capital gains should be taxed.

2.3.5 The McLeod Report

The McLeod Committee examined the issues surrounding the taxation of comprehensive capital gains. It first emphasised that the concept of comprehensive income was "a theoretical concept that can never be fully achieved under any real-world income tax" (2001b, p. 24). In particular, it highlighted the problems of measurement under an accrual-based CGT if a full comprehensive income definition were implemented. The concept was thus best regarded by the Committee as "a benchmark" which could be used to assess the properties of the income tax and of any potential changes to the tax system.

In considering the extent to which capital gains should be taxed, the committee agreed and accepted the arguments put forward by the Valabh Committee "on a theoretical level" (2001b, pp. 27-28). However, it rejected a realisation-based CGT (which is the most common form of tax in countries with a CGT), as it considered such a tax was far from the theoretical ideal of a CGT (i.e., an accrual-based CGT). A realised based CGT was a transactional tax on the disposal of assets, which was complex and costly to operate, and reduced the effectiveness of a CGT. In particular, the Committee identified several technical problems in implementing a realisation-based CGT. These were:

- The deductibility of capital losses. It considered that "allowing deductions for capital losses provides strong incentives for people to defer realising gains on assets that have increased in value but to accelerate realisations of assets that have fallen in value" (2001b, p. 27). As a result, this reduced the revenue derived from the tax and assets were tied up unproductively.

- Determination of a CGT realisation event. Under a realisation-based CGT, one must determine an event that would trigger a CGT. There were a "myriad of ways" to transfer the ownership of an asset where it was difficult to decide at what point a CGT event should occur. Defining all possible events and arrangements would be difficult and inevitably arbitrary.

- Problems with the application of rollover relief. Providing rollover relief could be economically desirable while other times might not. The rationale behind the concept of CGT rollover was that if there was no fundamental change to the economic ownership of an asset, no tax liability should be triggered when an asset was disposed of but replaced by a like asset. For example, rollover relief removed a tax bias against mergers in the share swap situation. However in other situations, a rollover might be economically undesirable. A taxpayer might be locked into investing in a particular type of asset continually "where other investments would be more desirable in the absence of tax considerations" (2001b, p. 28).

- Determination of asset coverage. The Committee considered the issue of what should constitute an "asset" for CGT purposes. Defining an asset and the cost measurement could be problematic especially for an intangible property.

The McLeod Committee also explored the CGT issues in other countries. It found that tax regimes in countries with a CGT "tend to be some of the most complex areas of tax law" and needed to be "interpreted and applied by taxpayers of relatively modest means" (2001b, p. 28). In these countries, CGT was perceived as "being unfair or unreasonable". Also the tax was subject to constant legislative changes which often resulted in "increasing arbitrariness in the application of the law" (p. 28). Furthermore, the compliance costs appeared to be disproportionate to the amount of revenue raised.

In its initial report, the Committee (2001b, p. 29), however, identified four significant gaps in the income tax base where the inconsistencies in the tax treatment of capital gains created problems. These were:

1. the inconsistent treatment of different saving vehicles
2. the impact on the treatment of offshore investment
3. the possible effects on investment in housing and
4. the likely opportunities that taxpayers might use to transform otherwise taxable income into capital gains in the absence of a CGT.

In the final report, the Committee argued that the disadvantages of taxing capital gains on a realisation basis outweighed any theoretical benefits, and, therefore, rejected the introduction of a CGT. It stated that:

> We do not consider that New Zealand should adopt a general realisations-based capital gains tax. We do not believe that such a tax would make our tax system fairer and more efficient, nor do we believe that it would lower tax avoidance or raise substantial revenue that could be used to reduce rates. Instead, such a tax would increase the complexity and costs of our system (McLeod Committee, 2001a, p. III).

It is noted that the committee recommended the adoption of a Risk-Free Return Method (RFRM) to address the problem areas, for example, designated investment vehicles and residential housing. The Labour Government later decided to implement the RFRM proposal. However, due to strong public opposition, RFRM was applied to savings and investment asset only. This shift leaves problems 3 and 4 above (effects on investment in housing and tax planning opportunities) unsolved.

2.3.6 The current position: post-McLeod report

Some of the McLeod proposals (such as the tax reforms on saving vehicles and offshore investment) have been introduced. It is yet to be seen what impact its proposals will have on the tax system in practice. It is also noted that a significant amount of Inland Revenue’s resources has been devoted to the rewrite of the

Income Tax Act, which is a long-term project to make tax law easier to use and understand. Moreover, the New Zealand Government was operating in fiscal surplus from 2001 to 2008. Therefore, there was little need to introduce new taxes (including CGT) to finance its expenditure. The McLeod Committee concluded that New Zealand should not adopt a comprehensive CGT on the grounds of complexity and high compliance costs – even at the expense of equity. This view reflects the Government's firm determination to reduce compliance costs for taxpayers.

2.3.7 Summary

In these government tax inquiries, there have been very mixed discussions on whether to expand the tax base so as to include more capital gains or to adopt a comprehensive CGT (see Appendix A for the summary). Besides, the tax inquiries approached the problems differently. The earlier reports by the Ross and the McCaw Committees focused on general issues of whether to tax capital gains. They utilised the general tax evaluation criteria such as equity and efficiency to determine if a CGT reform would address the problems of the New Zealand tax system. Later, as more capital gains were already covered in the tax system, both the Valabh and McLeod Committees accepted the concept of comprehensive income and took one further step by looking at the technical details and design features of a CGT.

It is revealed that the main reason for taxing capital gains is the equity principle which supports the notion that income and capital gains should be treated on the same basis since capital gains are important in assessing a taxpayer's ability to pay. On efficiency grounds, the introduction of a CGT would also reduce the deficiency in the system so that investments yielding capital gains are not taxed more lightly than other investments. Moreover, the lack of CGT provides a tax planning incentive for taxpayers to transform otherwise taxable income into capital gains.

The arguments against CGT are just as strong as the arguments for it. Most of these tax committees acknowledged that the major problems for taxing comprehensive gains were due to low revenue yield and implementation complexity. In general, most tax committees believed that the revenue of a CGT was affected by the fact that the current income tax system had already provided a wide coverage for the assessment of capital gains such as gains on disposal of land and personal property and that, under a realisation-based CGT, numerous deferral opportunities would exist resulting in further reduction in the tax revenue. They also argued that the introduction of a CGT would significantly increase taxpayers' compliance costs and Government's administration burdens (Commerce Clearing House New Zealand, 1988). Furthermore, there has been uncertainty over the application of the arbitrary distinctions over what constitutes a realisation event triggering a CGT, and what constitutes a rollover event. Therefore, as suggested by the McCaw Committee, "introducing substantial complexity for little revenue is not justified".

However, New Zealand's targeted approach, which taxes specific capital gains as income, is not itself without problems. As discussed earlier in section 2.1, Burman and White (2003) described the development of New Zealand's policy on taxing capital gains as "inconsistent" and somewhat "ad-hoc". This situation leads to detailed and often complex legislation as unintended incentives have been built into the tax structure. As such, a better approach in reforming the New Zealand tax system is to learn from countries with similar experience to that of New Zealand. In the next section, a review of the taxation of capital gains in OECD countries will be provided. The reasons for taxing capital gains in those countries will also be discussed.

2.4 Contemporary issues surrounding the taxation of capital gains in OECD countries

Established in 1961, the Organisation for Economic Co-operation and Development (OECD) is an international organisation of 30 member countries that are committed to democracy and a free market economy. According to Article 1 of the OECD Convention, its missions are to support economic growth, boost employment, raise living standards, maintain financial stability, assist other countries' economic development, and contribute to growth in world trade. It supersedes the Organisation for European Economic Co-operation which administered the Marshall Plan for the reconstruction of Europe after World War II. The Organisation provides a unique forum where governments compare policy experiences, seek answers to common problems, identify good practice and coordinate domestic and international policies. In particular, part of its mandate for overall surveillance of structural policy is to assess tax policy, which involves comparing tax design and policy across member countries, analysing their impact on economic efficiency and income distribution, and drawing specific country recommendations[33].

As at 2008, the OECD member countries are: Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

In an era of globalisation, New Zealand is increasingly using its tax system to improve its ability to compete globally in open economies. In particular, the mobility of capital income tax bases due to globalization may also increase the opportunities for tax avoidance and evasion. Therefore, a global overview of the tax system in the OECD countries, with special emphasis on the taxation of capital gains is provided in this section. Study of the CGT in these countries shows that it not only assists the design of tax reforms in New Zealand at the national level, but also enhances international tax policy cooperation among major trading countries.

2.4.1 Broad trends in taxation in the OECD

It is difficult to compare trends over time and across countries because of the different levels and mix of taxation. Despite some significant differences, there

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[33] The OECD Web site provides links to a variety of useful sources that discuss about the organization (http://www.oecd.org/pages/0,3417,en_36734052_36734103_1_1_1_1_1,00.html) and the Economics Department (http://www.oecd.org/department/0,2688,en_2649_34597_1_1_1_1_1,00.html).

seems to have been a trend of broadening the tax base with an objective of reducing personal and corporate tax rates across the OECD countries. While income taxes, taxes on goods and services, and social security contributions remain the three main sources of revenue, there has been a decrease in the share of tax revenue accounted for by personal income tax and consumption taxes but an increase in social security contributions over the last 30 years (OECD, 2006a).

Perhaps the most significant change in taxation is the steep decline in the top rates of personal income tax in OECD countries, as the unweighted average has fallen from 67% in 1981 to 49% in 1994 and 43% in 2006 (Johansson, Heady, Arnold, Brys, & Vartia, 2008, p. 13). A similar trend towards reduced rates is also evident in the top marginal tax rate on capital income (including capital gains, dividend, and interest income). Such reduction reflects a significant reduction in the corporate tax rates (OECD, 2006a, p. 23).

Another trend in personal income taxation is that some OECD countries, mostly Scandinavian countries, have moved towards a dual income system[34] (Johansson et al., 2008, p.14). In practice, however, the majority of OECD countries use modified comprehensive income systems which can be characterised as having a "semi-dual" nature (Johansson et al., 2008, p. 14). In these countries, certain forms of capital income are taxed at low and flat rates and remaining forms of income at higher and progressive rates. Moreover, most OECD countries favour certain types of savings and investment (such as owner-occupied housing) over others (such as bank deposits). As such, the OECD countries differ widely in their taxation of capital gains, a situation which is discussed in more detail in next section.

2.4.2 Taxation of capital gains

An overwhelming majority of OECD countries have some forms of general CGT regime in place with the only exceptions being New Zealand and the

[34] A dual income tax system taxes personal capital income (such as capital gains) at a low and flat rate while labour income continues to be taxed at high and progressive rates.

Netherlands[35]. Most of these countries have tax systems that are designed to follow the principle of the Haig-Simons' comprehensive income. However, due to the variations in their tax systems, no OECD country has actually implemented a pure comprehensive system which taxes all types of income on accrual basis. In practice, all CGT are based on a realisation basis. The tax systems can generally be characterised as having either "semi-comprehensive" tax systems (where capital gains are taxed at the progressive rates – the same as ordinary income) or "semi-dual" tax systems (where capital gains are taxed at a lower, flat tax rate) (OECD, 2006a, p. 84). Moreover, some countries (such as the United States) have a stepped rate so that the tax rate for CGT decreases if the holding period increases. Some (like Ireland) have a flat rate while others (such as Australia and Canada) use a discount system for taxing capital gains (only a proportion of the gain is taxable) (Australian Government, 2006, p. 206).

Notwithstanding the differences among the CGT systems in the OECD countries, it was found that, in a large survey of 20 OECD countries[36], there were several important policy considerations for the introduction of a CGT regime (OECD, 2006b). These included: (1) securing tax revenues; (2) efficiency considerations; (3) horizontal and vertical equity considerations; (4) encouraging savings and investment; and (5) simplicity considerations and tax compliance and administration issues. These are discussed in detail in the following sections.

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[35] Although the Netherlands has no CGT, it has an innovative 'box 3' tax system which taxes imputed (accrued) income from capital. Certain capital gains are taxed on an assumed (notional) yield of 4% on average net capital assets of households. This serves as proxy actual returns in the form of a mix of current dividend plus capital appreciation – which is also adopted in New Zealand as the Risk-Free Return Model or the Fair Dividend Rate method for the taxation of capital gains in foreign investment funds.

[36] These twenty OECD countries are: Australia, Canada, the Czech Republic, Denmark, Finland, Germany, Iceland, Ireland, Italy, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Portugal, the Slovak Republic, Spain, Sweden, the United Kingdom, and the United States.

2.4.3 Securing tax revenues

Securing tax revenues and protecting tax bases are identified as key objectives of CGT legislation in OECD countries. By having a general CGT, the problem of tax avoidance is mitigated to some extent as a CGT counters the taxpayers' incentives to convert taxable income into tax-exempt capital gains. For example, in Australia, tax planning activities to convert income receipts or characterise them as capital gains were common before the introduction of its CGT legislation. Also the lessening of an arbitrary distinction between income and capital for tax purposes was the main driving force for the introduction of a comprehensive CGT in Australia in 1985.

In addition to protecting the tax base by tackling tax avoidance strategies, the introduction of a comprehensive CGT helps to collect tax revenues on the "*bona fide* capital gains part of a comprehensive measure of income" (OECD, 2006b, p. 32). This follows the Haig-Simons' comprehensive income definition where it makes no distinction between income on revenue account and income on capital account. The expansion of the income tax base to collect more revenue was one of the major reasons cited by Ireland and the United Kingdom for taxing comprehensive capital gains. It is noted that, in the case of the United States, capital gains are always understood to be part of income and have been taxed since the introduction of income tax in 1913.

However, some tax avoidance opportunities still exist in countries with a comprehensive CGT due to the differential treatment between short-term and long-term gains. For example, tax sheltering activities have been detected in Spain[37]. Short-term capital gains are taxed as ordinary income (which is subject to progressive tax rates) while long term net capital gains are taxed at a flat tax rate of 15%. Taxpayers, therefore, take advantage of the tax rate differentials by creating financial instruments which are designed to transform income into long-term capital gains.

[37] According to the OECD report (2006b), countries with similar differential tax treatments such as Iceland, Ireland, Norway and Sweden are all facing similar tax sheltering problems.

2.4.4 Efficiency considerations

Efficiency is another important consideration in designing the OECD countries' CGT regimes. The effects of a CGT, in terms of efficiency, are, however, uncertain. On the one hand, in the absence of a CGT, it is argued that there will be excessive investment in assets which, though they yield a relatively low return, are especially likely to appreciate in capital value. People will tend to hold assets for speculative purposes rather than for productive ones if capital gains are tax-exempt. In particular, since capital gains assets are generally more risky than other assets, the absence of a CGT will provide an incentive for investors to take risk above the optimal level.

On the other hand, since most capital gains are taxed on a realisation basis, the tax will tend to lock people into exempt-asset investments in order to avoid tax for as long as possible, or lead them to delay selling existing assets. This phenomenon is often referred to as the "lock-in" effect. Moreover, because of the lock-in problem, taxpayers may tend to sell their loss-making assets in order to obtain the tax relief on loss deductions. In theory, this behaviour may result in less optimal outcomes and impose social costs as the value of an efficient investment portfolio cannot fully compensate for the additional CGT tax burden.

Therefore, while exempting capital gains may distort the allocation of resources toward capital gains assets and encourage risk-taking beyond levels consistent with tax neutrality, a realisation-based CGT introduces 'lock-in' effects and related inefficiencies. The international experience suggests that the majority of the OECD countries identify the neutrality of the tax system as the more important. While these countries also acknowledge the lock-in effects as "being of some concern", the problem, however, is not significant enough to discourage the taxation of capital gains (OECD, 2006b, p. 58). Countries such as Czech Republic and Portugal which consider the lock-in effects as a significant deterrent, generally exempt certain "non-speculative" gains to avoid lock-in incentives. On balance, the advantages of taxing capital gains generally are judged as being more important than efficiency losses from lock-in.

2.4.5 Equity considerations

Another main reason for taxing capital gains is largely influenced by the notions of equity. As discussed previously, economists, especially scholars from the Haig-Simons' school, considered capital gains to be part of ordinary income. An increase in wealth constitutes an increase in the ability to pay in much the same way as do receipts of ordinary income, such as salaries, interest, and rents. The gains confer an advantage on the taxpayer's taxable capacity. In economic terms, an increase in wealth due to the retention or the disposal of capital assets is hard to distinguish from an increase due to the receipt of a dividend. It follows that as long as there is an increase in wealth, the capital gains, whether accrued or realised, should be taxed. If capital gains are not taxed, this omission will contravene the horizontal equity.

For example, in the United Kingdom, CGT was introduced in 1965 to improve the fairness in the tax system by ensuring that capital gains earned by individuals were captured under the tax base. Similarly, 9 years later, Ireland introduced its CGT in 1974 with an objective to strengthen the equity between salary earners and taxpayers making capital gains (OECD, 2006b, p. 14).

The consideration for vertical equity is also important. Taxing capital gains is a way of reducing economic inequalities in wealth because capital gains are derived predominantly by high-income taxpayers, and the percentage of income realised as capital gains rises with income (Krever & Brooks, 1990). The Australian CGT experience revealed that the exclusion of capital gains from its income tax base prior 1985 conflicted with the principle of vertical equity and provided significant tax avoidance opportunities (OECD, 2006b, p. 63). Overall, the majority of OECD countries consider the current design of the CGT provides a fairer treatment by the tax system as a whole.

2.4.6 Encouraging savings and investment

Another advantage of a CGT is that the tax can serve as a tool to encourage household savings and enterprise (Poterba, 1989). This view is evident in Canada as the importance of tax deferred savings (including the tax deferral due to the realisation-based CGT) is portrayed as a means to encourage household savings. In the United Kingdom, tax relief in CGT is seen as a supportive instrument to reinforce the policy objective to promote the financing of enterprise and individuals' savings. For example, the taper relief in the United Kingdom is designed to encourage investment in active business assets and to promote savings by tapering most employee shareholdings in their employer (more discussion of the taper relief in section 2.5.1). Similarly, in the case of Denmark, taxable labour income is allowed to be converted into tax-preferred capital gains (on shares, subscription rights, or purchase options) through the use of share option. The objectives are to "stimulate 'share culture', boost savings, investment and growth" (OECD, 2006b, p. 64).

2.4.7 Simplicity, tax compliance, and administration issues

The major reason for not taxing capital gains (particularly for the adoption of a comprehensive accrual-based CGT) is its high compliance and administrative costs. A CGT is relatively more complicated than other taxes to administer and its complexity has posed significant problems to both governments and individual taxpayers. As discussed earlier, most New Zealand tax committees considered that the CGT provisions in foreign jurisdictions were often extremely complicated to administer, because they were imposed on all gains from the disposal of assets and involved a number of tax reliefs. In addition, it was argued that the calculation of CGT was harder than the calculation of income tax because the computation of CGT normally required professional valuations.

It is noted that the Netherlands holds a similar position to that of New Zealand in opposing the introduction of a comprehensive CGT due to its complexity (OECD, 2006b, p. 65). However, the Netherlands' tax system, which taxed interest, dividends and rents but not capital gains, was not itself without problems prior to 2001. The absence of a CGT had led to the use of financial products to convert taxable income into tax-exempt capital gains. In order to address the tax avoidance problem, and at the same time to avoid the introduction of a realisation-based CGT, it introduced an innovative 'box 3' tax system. The objectives of the Box system were to reduce the tax rates and broaden the tax base. It taxed imputed income from capital (i.e., accrued gains). It distinguished three types of income i.e., Box 1 for wage income; Box 2 for taxable income from a substantial business interest; and Box 3 for capital income on all personally held assets, and applied different tax rates on these three types of income. The Box system reduced the compliance and tax administration costs as it avoided the complications of introducing a realisation-based CGT (OECD, 2006b, p. 15).

On the other hand, however, the OECD report revealed that not taxing capital gains might result in significant compliance and administrative costs (OECD, 2006b, p. 65). In particular, a CGT would simplify the tax law instead of increasing its complexity in some countries. This simplification is evident in the case of Australia. Australia introduced its realisation-based CGT in 1985. Prior to the introduction of a comprehensive CGT, considerable costs were incurred by taxpayers and the tax administration in dealing with uncertainty over whether a gain was on revenue account (taxable) or capital account (exempt). The benefits of simplification arose because of the reduction in the litigation cost as the capital/income boundary became less significant. In addition, the report found that compliance costs were minimised in Australia as capital gains were taxed comprehensively and tax planning arrangements needed to be aware of the general anti-avoidance provisions in the income tax law.

Similarly, in the case of the United Kingdom, it was first acknowledged that a CGT would create complexity and the tax was expensive to administer. However, it was later considered that the benefits of a comprehensive-based CGT would outweigh its disadvantages, and by providing an annual exemption allowance for small gains, the compliance and administrative costs would be minimised.

2.4.8 Summary

This whole section has provided a discussion on the apparent rationale behind the introduction of a comprehensive CGT in most of the OECD countries. New Zealand is the only OECD country that does not have some form of general CGT regime in place. As discussed in section 2.3, the major reason for not introducing a CGT is the low revenue yield. This situation arises because a significant amount of capital gains, that would be taxed at the corporate level under a comprehensive CGT, is already currently taxed at the shareholder level when capital gains are distributed as taxable dividends from the company to the shareholders. Under a realisation-based CGT, there are many tax deferral opportunities where taxpayers can delay the tax payment. Moreover, the uncertainties over the application of the arbitrary distinctions between a realisation and a rollover further complicate the deferral problem.

However, a survey of the experience of other OECD countries found that the opposition to a CGT resting on these grounds cannot stand. In considering the introduction of a CGT regime, the OECD report (2006b) found that the advantages of a CGT generally outweighed its disadvantages. Most importantly, a CGT provides the benefits of: (i) securing tax revenues, (ii) improving efficiency, (iii) strengthening the horizontal and vertical equity, (iv) encouraging savings and investment, and (v) simplifying the tax system. It is, therefore, important to consider the issue of taxing comprehensive capital gains in a wider context and to start to investigate numerous design issues in respect of the implementation of a CGT from a policy perspective. This issue will be discussed in the ensuing section.

2.5 Design of CGT rules

In order to consider the design and operation of a CGT, a brief review of the CGT systems in the selected OECD countries is first provided. At the same time, relevant New Zealand legislation is given for analysis. Five OECD countries with a comprehensive realisation-based CGT (namely, Australia, Canada, Ireland, the United Kingdom and the United States) are chosen to compare the way the capital gains of individuals are taxed. Australia, the United Kingdom and the United States are New Zealand's major trading partner countries. Canada and Ireland are broadly similar in terms of their overall tax burden and the role of the government sector in the economy. Moreover, English is the common language in these countries.

The five selected countries mentioned above have taxed capital gains for many years. The United States has taxed capital gains since it first introduced income tax in 1913. The United Kingdom introduced CGT in 1965, while Canada and Ireland enacted a comprehensive realisation-based CGT in the 1970s. Australia, being a relatively late comer, taxed comprehensive capital gains in 1985. The reasons for the introduction of each countries' CGT vary as the history and development of their CGT reflect their specific needs. This leads to differences in their treatment of CGT. It is noted that although CGT has been subject to constant public criticisms and amendments since the enactment of the tax, none of the above countries has ever abolished it.

In this section, a review on numerous CGT design issues in respect of the implementation of a CGT is provided by addressing the possible influences of a CGT in practice. These issues include: (1) CGT assets coverage; (2) realisation-versus accrual-based taxation; (3) treatment of the inflation component of capital gains; (4) CGT tax rates; (5) capital losses treatment; and (6) timing and rollover provisions. They are discussed in the ensuing paragraphs.

2.5.1 CGT assets coverage

One of the most important considerations for designing a CGT system is to examine the types of properties which can likely be subject to a CGT. A comprehensive CGT will tax all assets in general. However, to some extent, certain types of properties have generated more discussions in the literature and are more controversial in overseas jurisdictions. These include (a) company shares and corporate bonds, (b) land and private residence, and (c) personal use property.

(a) Company shares and corporate bonds

Capital gains on shares are generally taxable under CGT or specific income tax regimes. However, in the cases of Australia, Canada and the United States, preferential tax treatment is given for capital gains on shares held for a longer term before disposal. Australia and Canada apply a 50% inclusion rate to gains on assets held for at least 1 year. The United States taxes long-term capital gains at a preferential tax rate of 15%, applying a one-year threshold. Prior to April 2008, the United Kingdom provided a taper relief which gradually reduced the inclusion rate i.e., the longer a capital gains asset was held, the lesser the tax rate levied (the taper relief was later abolished on April 6th, 2008) (International Master Tax Guide, 2008). The reason for the preferential treatment is to mitigate the lock-in effect of the realisation-based CGT (as discussed previously in section 2.4.4). A relatively low tax rate (or a reduced inclusion rate) implies a reduction of tax to be deferred, relative to sale price, so that the lock-in incentives are reduced.

In contrast, full taxation applies for short-term capital gains on company shares which are held for less than 1 year. This taxation reflects the policy desire to charge "speculative" gains in the nature of business income and to address tax avoidance opportunities (OECD, 2006b).

Although there is generally no CGT on the gains of disposal of company shares in New Zealand, certain gains on company shares are treated as personal property for income tax purposes (as discussed previously in section 2.2.2). In addition, there are specific tax provisions which deem overseas income (including capital gains) derived from offshore companies and similar entities as taxable income. For example, under the Foreign Investment Funds regime, New Zealand levies fair dividend rate (i.e., imputed, accrued capital gains) on all income of the shareholder of foreign investment funds. This measure aims to prevent New Zealanders using tax havens for tax avoidance.

Regarding gains on corporate bonds, the five countries generally tax capital gains on debt instruments in the same manner as gains on shares. Similar treatment is also evident in other OECD countries. In contrast, New Zealand applies accrual taxation to debt instruments under the financial arrangement rules (as discussed previously in section 2.2.4).

Table 2.2 provides a review of the taxation of capital gains on company shares and corporate bonds in New Zealand, and the five selected countries.

Table 2.2 Treatment of capital gains on company shares and corporate bonds of individuals in New Zealand and five countries (as of 1 May 2008)

Country	Treatment of gain	
	Company shares	**Corporate bonds**
Australia	For shares held less than 1 year capital gain is included in assessable income, and for shares held more than 1 year a discounted capital gain (50%) is included. Taxed at marginal tax rate	Same treatment as shares
Canada	Half (50%) inclusion in net taxable capital gains and taxed at marginal (personal) rates	Same treatment as shares
Ireland	Included in net capital gains and taxed at 20% flat rate	Same treatment as shares
New Zealand	Not taxed Note: However, it taxes some income akin to capital gains under the normal income tax provisions.	Accrual taxation at marginal (personal) rates (Expected gains taxed on accrual basis, while unanticipated gains/losses taxed on realisation)
United Kingdom	Flat rate of 18% [1]Previously included in total net taxable capital gains taxed at top marginal personal rate on savings income and subject to tapering relief. Taper relief provided a maximum exemption of 75% for business assets or 40% for non-business assets held longer than 2 years.	Same treatment as shares
United States	Shares held for not more than one year are included in net short-term capital gains and are taxed at marginal (personal) rates. Shares	Same treatment as shares.

Country	Treatment of gain	
	Company shares	Corporate bonds
	held for longer than one year are included in net long-term capital gains and taxed separately at flat 15% tax rate.	

[1]The taper relief was abolished on April 6th, 2008.

Source: Adapted from OECD (2006c) Table I.6 and Australian Government (2006) Appendix Table 6.2.1.

It is generally considered that the real capital gains (after adjustment of inflation) from disposal of company shares have been minimal (McCaw, 1982; McLeod, 2001a), and that New Zealand's share market appears to be underdeveloped relative to those of many other OECD countries (Cameron, 2007). As noted by the McCaw Committee (1982), the aggregate real capital gains on equity investments "have been negative over the twenty year period". Moreover, the ability for investors to defer realisation of a gain and to neutralise it by realising capital losses on other assets made the revenue yield of a CGT very low.

(b) Land and personal residence

While capital gains realised on general lands and buildings are taxable under a comprehensive CGT, capital gains on principal residence are normally tax exempt (subject to certain conditions). In particular, four of the selected five countries (except in the United States) provide exemption on capital gains in respect of an individual's principal residence. In the case of the United States, a large exemption threshold is provided for individual and married couple joint filers. The preferential tax treatment of disposal of principal residence reflects the political sensitivity and social significance of taxing the family home. In New Zealand, specific provisions are evident in the Income Tax Act to tax certain capital receipts arising from land transactions (as discussed previously in section 2.2.3).

It is contentious to tax the capital gains on the disposal of a taxpayer's principal residence. CGT imposed on the principal residence will affect those shifting houses involuntarily (such as relocation of company office). This taxation will discourage people from moving to take up new employment since the tax payment on the sale of their home will mean that they will have to purchase a smaller house or borrow a home loan when purchasing a new house. This lock-in effect will result in efficiency loss as the tax might restrict the more economic use of house-room resulting from a move to smaller houses by those whose needs have changed (Sandford, 1967).

However, Oliver (2001) argued that the absence of a CGT might have encouraged New Zealanders to invest heavily in real estate. In order to solve the problem, Morgan (1999) suggested the introduction of a comprehensive CGT on land as the tax would neutralise the impact of tax on people’s decisions to prefer property over other investment opportunities.

Table 2.3 provides a review of the taxation of capital gains on residential property in New Zealand and five selected countries.

Table 2.3 Treatment of capital gains on residential property of individuals in New Zealand and five countries (as of 1 May 2008)

Country	**Treatment of gain**	
	Housing assets	**Principal residence**
Australia	For assets held less than 1 year capital gain is included in assessable income, and for assets held more than 1 year a discounted capital gain (50%) is included. Taxed at marginal tax rate	Exempt But partial capital gains inclusion extended to business or rental purposes
Canada	Half (50%) inclusion in net taxable capital gains and taxed at marginal (personal) rates	Exempt Recognition of no more than one principal residence per family at any one time
Ireland	Included in net capital gains and taxed at 20% flat rate Special 40% rate applies to gains on shares deriving their value from certain land developments	Exempt But gains on residence tied to development of the property are taxed at 20% flat rate

Country	Treatment of gain	
	Housing assets	**Principal residence**
New Zealand	Generally not taxed Note: However, taxation of gains if held for the purpose of resale, also gains made by land dealers, developers and builders and gains arising from the rezoning, subdivision or development of land are taxable	Exempt
United Kingdom	Included in total net taxable capital gains taxed at marginal personal rate.	Exempt
United States	Assets held for not more than 1 year are included in net short-term capital gains and are taxed at marginal (personal) rates. Assets held longer than 1 year are included in net long-term capital gains and taxed separately at flat 15% tax rate.	Taxable Gain is included in net capital gain and taxed at lower capital gains rate, with an exemption threshold of USD 250,000 for individual or USD 500,000 for married persons filing jointly if owned and occupied by taxpayer as principal residence for 2 or more years over prior 5 years. Losses from principal residences are not deductible.

Source: Adapted from OECD (2006c) Table I.6 and Australian Government (2006) Appendix Table 6.2.1.

(c) Personal use property

There are two different types of personal assets for CGT purposes i.e., collectables such as coins, stamps, jewellery and artworks, and other personal use property such as home appliances, sailboats and private motor vehicles. Gains realised on collectables are generally taxable while gains from other personal use property are non-taxable (subject to certain conditions) under CGT regimes. Also, four of the selected five countries (except the United States) provide a small exemption threshold for personal property. For example, in Australia, collectables acquired for a market value of $500 or less and $10,000 for personal-use assets are exempted for CGT purposes. The exemption is €2,540 in Ireland and £6,000 in the United Kingdom at the time of disposal (HM Revenue and Customs, 2007; Irish Revenue, 2005). In Canada, where either the cost base or the proceeds of disposition are $1,000 or less, the cost base or the proceeds are deemed to be equal to $1,000. There will be no capital gain or loss if both the cost base and the proceeds are $1,000 or less (Canada Revenue Agency, 2007). In contrast, in the case of the United States, long-term capital gains from the sale of collectibles can be taxed at a maximum rate of 28% (depending on an individual's marginal ordinary income tax rate) without any exemption threshold. In New Zealand, there is generally no CGT on personal use property (as discussed previously in section 2.2.2).

It is also noted that since most personal property declines in value due to the taxpayer's personal use of the property, capital losses on the sale of it are generally non deductible. Rather than prohibiting the full deduction of capital losses, some countries ring-fence certain capital losses of personal use property against other capital gains. For example, in Australia and Canada, two types of personal use assets are identified i.e., collectables and other personal property. Capital losses from collectables (such as coins, stamps, jewellery and artworks) are deductible while other personal use property is non deductible. Moreover, the losses can be deducted against capital losses on collectables only, but not against other general capital gains such as gains on shares (more discussion of capital loss in section 2.5.5). Table 2.4 summarises the treatment of capital gains on personal use property.

Table 2.4 Taxation of capital gains on personal use property of individuals in New Zealand and five countries (as of 1 May 2008)

Country	Capital gains	Capital losses
Australia	Yes with exemption threshold	Yes. Capital losses on collectables deductible only from capital gains on collectables. No capital loss allowed for personal use assets
Canada	Full inclusion*	Yes. Capital losses on listed personal property only from capital gains on listed personal property
Ireland	Yes with exemption threshold	No deduction allowed
New Zealand	Not taxable But taxable if dealer in property, acquired for resale purposes or profit-making scheme	No deduction allowed However, if the income is deemed to be taxable, a deduction is allowed
United Kingdom	Yes with exemption threshold	No deduction allowed
United States	Full inclusion Capital gains on collectables can be taxed at a maximum rate of 28%	No deduction allowed

*Exempt if the cost base and the proceeds are $1,000 or less

Source: Adapted from OECD (2006c) Table I.6

It is argued that a realised capital gain on assets held for personal use is of no advantage to the user unless the person can do without the assets in question (Sandford, 1967). In most cases, when a personal-use property is sold, the receipts will be used to repurchase a similar type of property. Any gain realised on the sale of a personal property will be like a windfall gain, for example, a Lotto (lottery) win for a taxpayer, and therefore, such a gain should be exempt. If capital gain on all personal-use property were taxable, the tax would be more complicated to administrate as taxpayers would be required to keep a record of the costs of all of their personal-use properties.

It is also noted that most personal-use properties seldom grow in value as these assets normally decline in value due to personal consumption. However, the same is not true of collectables which will likely increase in value due to economic conditions. Moreover, on neutrality and equity grounds, capital gain on disposal of a personal use property should be treated the same as gain on disposal of other capital property (Krever & Brooks, 1990). If a gain on personal use property arises and is realised by a taxpayer, this gain will increase the taxpayer's ability to pay, as with other forms of capital gains.

Morgan (2001) advocated the introduction of the minimum dollar threshold for small capital gains. He argued that doing so would exempt small capital gains "where the economic cost of compliance outweighed the national benefits that flow from neutralising the capital/income boundary as tax liability was concerned" (p. 23) and that instead of applying solely on personal use property, this minimum threshold should also be applied to all types of assets uniformly.

2.5.2 Realisation- versus accrual-based taxation

All five countries use a realisation-based CGT system. It is argued that such a tax structure distorts market and taxpayers' behaviour because of the lock-in effect[38] and bunching effect (Singleton, 2003). For example, in Australia, some taxpayers' income may be extraordinarily high because gains in each year are accumulated and added to their income in the year they dispose of the property. As a result, the taxpayers have to pay CGT at a higher marginal tax rate because of the larger gain (Ross & Burgess, 1996). This phenomenon is often referred to as the 'bunching' problem.

[38] The lock-in effect is that the tax locks people into exempt-asset investments in order to avoid tax for as long as possible, or lead them to delay selling existing assets (refer to section 2.4.4).

Many countries provide CGT discounts and averaging provisions like those in the Australian CGT in order to mitigate the bunching problems (averaging was later repealed by the Australian government in 1999). Administration is another major problem. Valuation is sometimes required both when an asset is bought, and when it is sold. Moreover, defining the timing of the realisation is particularly important (more discussion in section 2.5.6).

There are strong theoretical grounds to support the introduction of an accrual-based CGT in the five countries and New Zealand. In theory, an accrual based CGT which taxes capital gains at the same effective rate across all investment provides neutrality to the tax system and avoids distortion. However, accrual taxation is hard to operate in practice due to its valuation and liquidity problems. In fact, no country applies an accrual-based comprehensive CGT and therefore most capital gains are taxed on a realisation-basis[39] (OECD, 2006b).

Morgan (2001) suggested several measures to combat the problems of an accrual-based CGT. He argued that the asset valuation could be calculated by reference to movements in a common asset price benchmark. To overcome the liquidity problem, he suggested that the government could provide interest-bearing loan finance to taxpayers who might not have the money to pay the accrual CGT. He also proposed a use of money charge paid annually when the taxpayers opted to pay CGT on a realisation basis. Under his proposal, taxpayers would be given the options to choose from either taxing capital gains on the accrual or realisation basis.

In response to Morgan's suggestions, Shewan (2001a, 2001b, 2001c) strongly opposed the introduction of a comprehensive CGT, and in particular, he was disgusted by the accrual taxation approach. He argued that such a system would breach the simplicity principle. He continued that there was no satisfactory indicative asset benchmark to apply in valuing most business assets, and that even

[39] New Zealand is the one of the two OCED countries (the other is Australia) that applies accrual taxation to expected gains on corporate bonds (OECD, 2006b).

if there were any, it would involve a huge bureaucracy to issue indicative percentage of any change in asset value each year.

2.5.3 Treatment of inflation component of capital gains

An ideal comprehensive CGT should include real capital gains in the tax base. In practice, however, the method of taxation normally fails to distinguish real capital gains and nominal gains as most OECD countries do not attempt to adjust the effects of inflation. This circumstance is due partly to the complexity of and partly to the belief that inflationary gains are no longer as prevalent as they once were (OECD, 2006b). For example, Australia, Ireland and the United Kingdom used to provide indexation of gains. But their systems of indexation were later replaced by preferential CGT tax rates or a CGT inclusion discount due to the complexity of the old regimes. Table 2.5 provides a review of the treatment of the inflation component of capital gains in the five selected countries.

Table 2.5 Treatment of inflation component of capital gains in five countries (as of 1 May 2008)

Country	**Indexation**
Australia	No (But indexation applies to assets acquired before 21 September 1999 and calculated up to September 1999)
Canada	No
Ireland	No (But gains made where the asset was originally purchased before 2003 attract indexation relief)
United Kingdom	No (Both indexation and taper relief were abolished in 1998 and 2008 respectively)
United States	No

New Zealand appears to recognise the negative impacts of inflation on the tax system. The McCaw Committee (1982) found that horizontal inequity would occur unless adjustments were made for inflation in the tax base as a whole. On efficiency grounds, it was suggested that the CGT system should be adjusted for inflation so that only real profits were taxed and investment direction would not be distorted. Similarly, the McLeod Committee (2001b) discussed the impacts of inflation on the effective tax rates and showed that the tax system could tax a person at more than 100 percent of real income if relief were not provided for the effects of inflation. The issue of inflation was considered so important by the Valabh Committee (1989) that it went further one step by introducing a comprehensive inflation allowance regime.

Despite the inequity and inefficiency for taxing nominal gains, many countries, including New Zealand, do tax nominal gains. As such, it was suggested by some scholars that a tax system with no indexation would still work well enough for ordinary current income because the inflation was moderate (Krever & Brooks, 1990; Evans & Sandford, 1999).

2.5.4 CGT tax rates

There are two different approaches regarding tax rules for taxing capital gains. The first is to tax capital gains at a preferential rate which is lower than the ordinary income tax rate. The advantage of this approach is that it encourages taxpayers to realise gains more frequently and thus reduce the lock-in effect of the CGT. People's tendency to realise gains more often would result in increases in revenue for the government (OECD, 2006b). Also, a lower tax rate would boost investments and attract foreign investments. However, the problem with a preferential tax rate is that it is likely to encourage taxpayers to transform income to capital gains because of its lower rate. Hence, stronger and more specific anti-avoidance measures, rather than general anti avoidance ones, would need to be introduced to stop taxpayers from abusing the preferential rate of tax (OECD, 2006b, p.105).

As discussed in sections 2.4.1, a number of Scandinavian countries (such as Sweden, Iceland and Norway) adopt a dual income tax system whereby personal capital income (such as capital gains) is taxed at a lower rate while labour income is taxed at higher and progressive rates. In these countries, dividends, interest and capital gains are aligned so that the system provides a level playing field and avoids tax-distortions to asset choice. However, in practice, tax avoidance incentives still exist as capital gains (which are generally charged at a lower flat tax rate) are not aligned with the higher marginal tax rates on labour income (OECD, 2006b, p.106).

The second way to taxing capital gains is to tax them at the taxpayer's ordinary marginal income tax rates. This approach is based on the Haig-Simons' comprehensive income theory. On neutrality grounds, capital gains should be treated in the same way as ordinary income for tax purposes since doing so increases the taxpayer's ability to pay. It is also more equitable; otherwise, the inequities created between taxpayers who earn income from labour and those who earn income from property (which has appreciated in value) will be significant if taxpayers with appreciated property only pay tax at a lower rate.

In fact, most of the OECD countries (including the five selected countries) have tax systems that are designed to follow such a comprehensive income approach. However, as discussed in section 2.4.2, all CGTs are designed on a realisation basis which deviates from an ideal comprehensive system which assumes all types of income should be taxed on an accrual basis. The major reason is the lock-in effects of a realisation-based CGT. Another reason is inflation. Table 2.6 provides a review of CGT tax rates and the differential tax treatment between long- and short- term gains in the five selected countries.

As shown in the table, all the selected five countries provide certain preferential treatments to the taxation of capital gains. In Ireland and the United Kingdom (after April 2008), capital gains are taxed at a lower, flat tax rate. In the United States, a stepped rate is provided so that the tax rate for CGT decreases if the holding period increases. Alternatively, Australia and Canada use a discount system for taxing capital gains which exempts half of the taxable capital gains if the holding period is more than 1 year. It is important to note that in order to qualify for these discount tax rates and/or the indexation adjustment, one must hold the CGT asset for 1 year or more. Evans and Sandford (1999) argued that such a distinction between short-term and long-term capital gains would distort economic decisions. Also the differences in treatment would complicate the complexity of the tax regime, and violate the fundamental principle that capital gains should be treated as ordinary income.

Table 2.6 CGT tax rates and distinction between long- and short-term gains in five countries (as of 1 May 2008)

Country	Tax rates	Distinction between long term and short term gains
Australia	Marginal income tax rates with 50% CGT discount for long term gains	Yes
Canada	Marginal income tax rates with 50% CGT discount for long-term gains	Yes
Ireland	Preferential, Flat tax rate of 20%	No
United Kingdom	Preferential , Flat tax rate of 18%	No
United States	Preferential, long-term capital gains can be taxed at a maximum rate of 28% (depending on an individual's marginal ordinary income tax rate)	Yes

2.5.5 Capital losses treatment

Most countries generally do not provide symmetric treatment of capital gains and losses. All capital gains are included immediately as a part of income tax liability, whereas capital losses can be deducted against capital gains only with any excess capital losses carried forward to the following tax year(s) (Some countries allow carry back of capital losses.). For example, in Australia and Ireland, capital losses can be offset against capital gains only, and excess capital losses are carried forward indefinitely to offset capital gains in future years. No deduction against other income is allowed. Also trading income losses cannot be used to offset against capital gains. In Canada and the United Kingdom, capital losses from certain higher risk investments are deductible against income. For example, in Canada, 50% of capital losses on shares and/or debt of a qualifying small business corporation can be deductible against capital gains and taxable income from any source ("allowable business investment loss" rules). In the United States, excess capital losses of up to $3,000 can be offset against ordinary income. The treatment of capital losses in five countries is summarised in Table 2.7.

Table 2.7 Treatment of capital losses in five countries (as of 1 May 2008)

Country	**Capital losses deductible against other income/gains**	**Losses other than capital loses deductible against capital gains**	**Carry forward/carry backward**
Australia	No. Capital losses may be deducted only against capital gains. Note: Capital losses on collectables can only be deductible from capital gains on collectables. No capital losses on personal use assets	No	Carry forward indefinitely (no carry backward)
Canada	Yes, but only if the "allowable business investment loss" rules apply Note: Capital losses on listed personal property are deductible only against capital gains on listed personal property.	Yes	Carry forward indefinitely and carry backward for 3 years
Ireland	No. Capital losses deducted only against capital gains	No	Carry forward indefinitely

Country	Capital losses deductible against other income/gains	Losses other than capital loses deductible against capital gains	Carry forward/carry backward
			Carry backward for 3 years (for gains at death)
United Kingdom	Yes. Capital losses on shares in an unlisted trading company may be set off against income of the current tax year or following tax year. Other capital losses generally cannot be deducted against other forms of income or gains	Yes	Carry forward indefinitely Only carry backward for gains at death
United States	Yes. Excess capital losses of up to US$3,000 may be set off against ordinary income.	No	Carry forward indefinitely

Source: Adapted from OECD (2006c) Table I.6 and Australian Government (2006) Appendix Table 6.2.1.

This non-deductibility of other income which introduces non-neutralities and asymmetries in the tax is justified only by protecting the tax base and prohibiting taxpayers from exploiting the concession (Cheng, Hooper, & Davey, 2000). As noted by the McCaw Committee (1982), investors have tended to take advantage of the relief for capital losses by deferring realisation of a gain, while selling and possibly repurchasing capital gains assets just sufficient to claim the capital loss deduction, and neutralising the gain by realising capital losses on other assets. Moreover, it was argued that very generous loss offset provisions would provide an incentive for taxpayers to characterise certain personal consumption activities (e.g., a hobby farm) as business activities in order to obtain tax deductions for consumption expenses (OECD, 2006b, p.106).

However, Krever and Brooks (1990) argued that restricting capital loss deductions to protect government revenue could not be justified simply on the ground of revenue protection. For equity and neutrality, capital loss should be deductible against other income. Non-deductibility of losses against other income would create non-neutrality in the investors’ view. Risky investments would become even riskier and make a stronger bias towards safer investments.

2.5.6 Timing of realisation and rollover provisions

The timing of the CGT liability recognition is important under a realisation-based CGT. In general, a CGT liability is triggered when a capital gain (i.e., the sale proceeds less cost of acquisition) is realised. The proceeds of sales generally include any receipt from the sale less any expenditure associated with the transaction. In contrast, the computation of the cost base (or cost of acquisition) is more restrictive for CGT purposes. For example, in Australia, the “cost base” of an asset can be defined (Evans, 2004, pp. 2-54) as the sum of:

a) the amount of any consideration in respect of the acquisition of the asset
b) the amount of any incidental costs to the taxpayer of the acquisition of the asset
c) the amount of the non-capital costs to the taxpayer of the ownership of the asset, where the asset is a personal-use asset of the taxpayer
d) the amount of any expenditure of a capital nature incurred for the purpose of enhancing the value of the asset and is reflected in the state or nature of the asset at the time of disposal of the asset
e) capital expenditure associated with title to the asset

It is also noted that the terms “acquisition” and “disposal” may have a wider meaning on the application of the legislation in practice. The Oxford Dictionary defines “acquire” as to “gain by and for oneself or come into possession of (a property)”; and “dispose of” as “to deal with, get rid of and sell”. The ordinary usage of these terms suggests that this definition encompasses the sense of the mere receipt of a possession, and the subsequent sales of the property being cessation of the title or ownership. However, there may be situations (or CGT events) where no physical changes have taken place. For example, a property may be deemed to be “disposed of” by a person when he/she dies or when he or she ceases to be a tax resident of a country. The ambiguity in the ordinary meaning of both terms would lead to uncertainty in the application of CGT (Evans & Sandford, 1999). To tackle these definition problems, a CGT event approach is used in Australia. This sets out the events that will trigger a CGT liability and specify the tax treatment in those circumstances.

Regarding the timing of the CGT recognition, it is common for a country with CGT to include non recognition or roll-over provisions that enable taxpayers to defer payment of CGT that might otherwise be triggered. In general, there are two types of rollovers i.e., same asset rollovers and replacement asset rollovers. Same asset rollovers involve the transfer of a given asset amongst different taxpayers. Under the rollover relief, the gain on disposal of an asset is disregarded for CGT purposes and the CGT attribute of the asset will be rolled over from one taxpayer to another. As a result, no CGT is incurred on the disposal by the transferor, while the CGT liability will be accumulated by the transferee. A CGT will be triggered on the transferee’s subsequent disposition. In contrast, replacement asset rollovers apply when one taxpayer disposes of an asset and replaces it with a similar one. This rollover regime has the effects of disregarding the CGT on disposal of the original asset and passing the capital gain onto the cost of the replacement asset.

Generally, all the selected five countries provide same asset and replacement asset rollovers. For example, all these countries provide same asset rollover for the transfer of asset between spouses (in the event of a marriage breakdown). In contrast, the types of replacement asset rollovers are different in the five countries. In general, replacement asset rollovers are available for the gains on incorporation of a business (asset-for-share transaction), replacement of business asset (asset-for-asset transaction) and merger and acquisition (share-for-share transaction) with the exception of Ireland, where no provision has been made for asset-for-asset rollover. All in all, some restrictions are noted. For example, in Australia, the share-for-share exchanges are only available for the exchange of shares in an original company for shares in the new company in the event of a merger or takeover. Asset-for-asset rollover is provided for small business replacement assets, assets compulsorily acquired, lost or destroyed; strata title conversions, scrip for scrip exchanges, and renewal or surrender of statutory licences. Lastly, asset-for-share rollovers apply to any transaction involving the exchanges transfer of assets from a sole trader (or partnership) business to a company wholly owned by the sole trader (OECD, 2006b). The rollover provisions in the above five countries are summarised in Table 2.8.

Table 2.8 Rollover provisions in five countries (as of 1 May 2008)

Country	**Same asset rollover**	**Replacement asset rollover**		
	Spousal transfer	Share-for-share exchanges*	Asset-for-asset exchanges*	Asset-for-share exchanges*
Australia	Yes	Yes	Yes	Yes
Canada	Yes	Yes	Yes	Yes
Ireland	Yes	Yes	No	Yes
United Kingdom	Yes	Yes	Yes	Yes
United States	Yes	Yes	Yes	Yes

*Restrictions apply.
Source: Adapted from OECD (2006b) Table 3.4, OECD (2006c) Table I.6 and Australian Government (2006) Appendix Table 6.2.1.

The rollover provision is justified on the presumption that, if the disposal is essentially a paper transaction (that is, there is a change in form but not substance), taxpayers should not have attained any gains in reality because the taxpayer’s position is similar to what it was before the disposal as the taxpayer still owns the property of the same type. In other cases, business organisations are reluctant to reorganise their business structure as it may incur a significant CGT liability. The rollover regimes are provided to mitigate the lock-in effect of CGT in such a business restructuring.

However, problems arise in defining which event will qualify for a rollover. From overseas experience, it is evident that there would be some restrictions on the rollover relief for certain events (such as the share-for-share exchange in

Australia). It is also argued that the economic benefits of rollover provision are not clear when the potential compliance costs to revenue of such provisions are considered. The negative impact of this provision can be significant as taxpayers may become less able to afford the tax after the deferral of tax (OECD, 2006b).

2.6 Theoretical models for tax policy and reform

Taxation is a constantly changing field because it has the difficult task of implementing public policy. This study aims at exploring the key issues, aspects and attributes concerning CGT in New Zealand to enable the formulation of policy guidelines that might be used if a CGT were considered in New Zealand. This aim was achieved by looking at the issue of taxing comprehensive capital gains in a wider context. Accordingly, there is a need to develop a framework of tax policy principles to guide the investigation of a complex tax system. An essential prerequisite in achieving this goal is to understand the three major schools of thought in regard to the design and reform of taxation, namely, the comprehensive income theory, the optimal tax theory, and the public choice theory.[40]

2.6.1 The comprehensive income theory

In Henry Simons' work "Personal Income Taxation" (Simons, 1938), the author provided a detailed analysis on the fundamental objectives and criteria of fiscal policy. The objectives were to promote individual liberty and to create an equitable tax system by having a comprehensive tax base. Emphasis was placed on (i) the logical consistency according to a single criterion of equity i.e., the ability to pay and (ii) a quantitative and objective procedure of measuring income. Accordingly, Simons rejected other theories such as the principle of economic efficiency and utility theory in developing the definition of a comprehensive income.

Tiley (2005) considered the Simons' comprehensive income approach relatively easy to understand. However, he argued that the problem of the approach was that

[40] For summaries of the three theoretical models, see Hettich and Winer (1985) and Tiley (2005).

its single idea of equity could not accommodate adequately the ideas of economic efficiency. While the Simons' approach focused on horizontal equity, it also provided "no structure for vertical equity" (p. 14).

Simons considered that capital gains must be treated as income and taxed at the time of realisation[41] and that other gains such as gifts, inheritances and lottery winnings should also be taxed. He argued that property tax and petrol tax should be maintained, but other taxes (such as the corporate tax) should be abolished. He also rejected special provisions or preferences.

2.6.2 The optimal tax theory

Whereas the school of comprehensive income focuses on the horizontal equity and measurability, the optimal tax theory is concerned with the identification of an ideal income tax definition (Holmes, 2001). The optimal tax theorists look at utilitarianism and the sacrifice theory with an emphasis that all taxpayers should suffer "an equal sacrifice", while maximising the average utility in an economy at the same time. It follows that taxpayers, who are in equal positions before a tax is imposed, are left in an equal position after it is imposed which means that the tax designers have to account for the welfare of the taxpayers and model the effects of a tax.

To demonstrate the applicability of the optimal tax theory, one may look at the deduction of expenditure. Griffith (1994) discussed how inefficiency of a tax system occurred when it failed to tax personal and business expenses properly:

> Suppose, for example, that in a no-tax world a doctor believes that attending a medical convention in Hawaii has a business value of $2,500 and a personal value of $ 2,000. If the cost of the attending the convention is $ 5,000, the doctor will not attend because the $ 5,000 cost exceeds the $ 4,500 benefit. Suppose, however, that the doctor can deduct the cost of the convention, but is taxed only on

[41] Simons was not worried about the deferral problem of a realisation based CGT, but his followers were (Tiley, 2005)

> its business value. If the doctor is in the 40% marginal tax bracket, the after-tax cost of attending the convention is $3,000 ($5,000 x 0.6), the after-tax business value is $ 1,500 ($2,500 x 0.6), and the (tax-free) personal value is $2,000 for a total after-tax benefit of $3,500 ($1,500+$2,000).
>
> Now the doctor will attend the convention because the after-tax cost of $ 3,000 is less than the after-tax benefit of $ 3,500. This is inefficient because the $ 5,000 pre-tax cost of attending the convention exceeds its $ 4,500 pre-tax value. (p. 1773)

Focusing on the consequences, both distributional and economic, enables the tax designers to decide the desired consequences and then shape the tax system accordingly. Since the government increasingly places great emphasis on the role of economic efficiency, the theory provides an important guide for tax design and serves as a basis on which the degree of vertical equity in the tax could be determined.

However, the problem of the approach is that the optimal tax theory has been criticised for being too idealistic to recognise the fact that it is too difficult to measure (Holmes, 2001). For instance, the optimal tax theorists highly value the utility gains/losses arising from leisure and often include them as part of the consideration on the development of an ideal income definition. In order to attain a workable model, a pragmatic compromise has to be made by making modifications to the ideal objective. Doing so means a subjective monetary value has to be used to model the taxpayers' well being (or utility). However, complications arise because the model omits values with no available market valuation (as in the case of endowments and tastes) which are important in determining the level of well-being of taxpayers and the ideal tax burden to be placed on them (Apps, as cited in Tiley, 2005). According to Apps, two problems occurred:

> (i) horizontal and vertical inequities due to 'errors'; the subjective monetary values are not perfectly correlated with the opportunities and well being of the individual, and (ii) efficiency losses due to

> incentive effects; the indicators are usually under the control of the individual and so taxing them is distortion (p. 15).

According to Holmes (2001):

> The practical mechanisms to determine which man pays tax, and how much tax, are normally tax exemptions, deductions or credits based on individuals' circumstances. A pragmatic tax system that is fair must be founded on this analysis; otherwise, some gains will not be recognised as income and will be excluded from the tax base altogether (for example, capital gains in countries such as the Netherlands and New Zealand), notwithstanding that some recipients may be quite able to pay tax imposed on the gain (p. 24).

2.6.3 Public choice theory

Under the public choice theory, it is assumed that the government is a benevolent dictator with a monopoly of power and resources (Brennan & Buchanan, 1979). According to Brennan and Buchanan, one of its greatest sources of strength lies in a government's power to tax. The public choice theorists consider that "the government is at risk of being taken over by malevolent interest groups" (Tiley, 2005, p. 15) as the traditional political processes on government constraint are inadequate and the system fails to meet the electorate's wants. Since the administration of the government is almost unconstrained, the government officials will likely act in their own interest rather than in the interest of society as a whole. Therefore, there is a need to protect taxpayers' need against taxation.

The public choice theorists study the nature of government in terms of the way the political process operates. The objectives are to control the power of the government and to reduce its revenue potential. Under this approach, the relationship between taxpayers and government officials is analysed on a basis similar to that of between consumers and a company. Ideally, taxpayers should be the tax designers and operators. If that is not possible, existing political institutions should operate behind a Rawlsian ‘veil of ignorance’ (Tiley, 2005, p. 15).

The problem with this approach is that the theory reveals little about the ideal tax structure (Tiley, 2005). It focuses on the acceptability of the process rather than the result. If the process is acceptable, the public choice theorists accept any loophole in such a system.

2.6.4 Conflict between different evaluation criteria

Hettich and Winer (1985) provided a thorough analysis of the three schools. While the Haig-Simons’ scholars focused on the wide coverage of the income tax base and the optimal tax theorists were concerned with the effects of changes on the welfare of households and the maximisation of average utility of the economy, the public choice theorists wanted to restrict government controls and promote the role of taxpayers as the consumers of public goods and services. In short, different emphases were placed by these schools: (i) objectivity and measurability of a tax for Haig-Simons, (ii) an ideal tax structure for the optimal tax theorists and (iii) universal acceptability of the tax processes for the public choice theorists. At the end of their analyses, the authors concluded that the three schools clashed sharply and a new synthesis was necessary for future development of taxation theory.

Most importantly, the divergence of tax theories may give rise to conflicts in the tax criteria used in tax design. The extent and nature of those conflicts will depend upon which school of economic thought one belongs to. In this respect, one must first consider the principles of good taxation and the four evaluation maxims which were identified by Adam Smith about 200 years ago. These are: (i) equity, (ii) certainty, (iii) convenience, and (iv) administrative efficiency (Smith, 1947, pp. 307 – 308). According to Smith, tax should be charged as nearly as possible in proportion to ability to pay; it should be certain, and not arbitrary; it ought to be charged at a time most convenient to the taxpayer, and the collection and administrative costs of the tax should be as low as possible. A good tax structure must take account of these factors. In modern usage, Smith’s four canons of taxation are condensed into three criteria, namely, (1) equity, (2) efficiency, and

(3) simplicity. The criterion of equity embraces horizontal equity and vertical equity[42], and is partly related to the concept of certainty[43]. Efficiency is about the convenience and certainty of a tax to the taxpayer, and the cost of collection and compliance to the taxing unit (i.e., the administrative efficiency). Lastly, a tax system should be as simple as possible, and taxes should be easy to understand and comply with. The concept of simplicity is associated with the certainty and convenience maxims.

As mentioned in 2.6.1 and other earlier sections, the prevailing school is the "equity" one or the Haig-Simons' comprehensive income theory. This concept of equity is paramount in a number of tax systems in foreign countries. If a tax system is believed to be fair and equal, taxpayers will be more willing to comply with the tax laws. In Canada, the Royal Commission on Taxation (1966) supported equity as the major objective of income tax policy. It is noted that equity has been incorporated in varying degrees in most tax systems around the world (Downer, 2001). To define the concept of equity, some commentators, therefore, argue that adjustments should be made for regional differences with regard to amenities and living costs. In assessing how equitable a CGT is, attention must be paid to other tax matters (such as the progressivity of tax rates) and the social system as a whole. For example, Singleton (2003) looked at the tax burden of taxpayers and considered that a CGT was not fair. He argued that due to the comprehensive nature of a CGT, more taxpayers in the lower bracket than those in the higher one would pay the CGT as there were more taxpayers in lower brackets than in higher ones.

In contrast, the optimal tax theorists focus on matters of efficiency and international relations. The principle of efficiency is based on the assumption that the tax system should not modify the behaviour of taxpayers or at least should not modify their behaviour in ways not intended by the legislation. In this respect, the

[42] The principle of horizontal equity requires that taxpayers in identical situations should be taxed equally, while vertical equity requires that taxpayers in different situations should be treated differently so that a greater tax burden should fall on people who have greater capacity to pay.

[43] This enables a tax to be charged with certainty and without arbitrariness.

introduction of a CGT will promote the neutrality of the tax system as tax-driven tax avoidance activities are mitigated. New Zealand is one of a few OECD countries without a comprehensive form of capital gains taxation. It is not surprising to see that the OECD advocated a significant broadening of the income tax base by including capital gains in a more comprehensive way in its 2000 report (OECD, 2000, p. 127). Dixon (2003), in promulgating the research assumption, stated that "New Zealand will eventually follow the approach on the United States, the United Kingdom, Australia and most other OECD 'First World Nations' and extend the tax base to include capital gains" (p. 331).

On the other hand, the negative lock-in effects under realisation-based CGT are considered equally important and are the reason why New Zealand does not follow the conventions of most OECD first world nations to extend the tax base to include comprehensive capital gains. The Tax Review 2001 (McLeod Committee, 2001a) acknowledged the OECD comments about the glaring anomaly found in the New Zealand tax system, and rejected CGT in favour of a novel approach – a risk free return method (RFRM) – to deal with problems arising from the tax system (p. 29). Moreover, some researchers considered that the absence of CGT in New Zealand would constitute a competitive advantage (Shewan, 2001a). It was argued that the impact of globalisation was such that capital would flow to where it could obtain the best returns.

The role of tax changes in altering economic activities is now accepted, although mechanisms such as monetary control and fiscal expansion are other, more useful, devices in changing the economy. Sometimes, the tax system can be used for specific purposes, such as discouraging the consumption of alcohol or cigarettes. It has been suggested that a CGT can play a role in curbing the economic distortions in investment. The OECD report (2000) argued that the New Zealanders' predilection for real estate property, rather than shares or other investments, was partly due to the non taxation of capital gains (p. 143). On the other hand, a CGT itself can be a distortion in investment decision. The tax may cause people to engage in conduct that they otherwise would not. It can sometimes have other unexpected consequences in the real world. On balance, the effects of CGT in terms of efficiency consideration are, therefore, uncertain.

The third school of tax theory – the public choice theory – must also be considered. The tax system expresses many political and social values. The CGT proponents and opponents, who hold different values, beliefs and social expectations, have participated actively on aspects of CGT tax rules. One important function of the tax system is to raise revenue to meet government expenditure. Another function is to redistribute wealth in a more equitable fashion. Capital gains are generally concentrated in the hands of high-income individuals, and social inequality arises when the non-taxation of capital gains provides more tax benefits to taxpayers in high-tax brackets than to those in low-tax brackets (Krever & Brooks, 1990). For many low-income families, the income from social assistance is often larger than the income they can earn from working. In some cases, the marginal tax rate in low-income families is higher than that paid by the wealthiest New Zealanders because the low-income families have no more control over the flow of their income and are unable to arrange financial affairs for the avoidance of taxes. One common way to avoid income tax is by converting taxable income into tax-free capital gains. Social tensions occur because the low- and middle-income earners, generally holding fewer capital assets than the high income earners, often believe they should receive larger social benefits and pay less tax. CGT is, therefore, considered by many OECD countries to be a good way to correct the inequality of the existing tax system (OECD, 2006b).

Moreover, tax is a means of staying in power for political parties. In reality, it is influenced by political ideology rather than taxation and economic principles. In particular, a CGT is the most pervasive and privileged exercise of political power in New Zealand. CGT will have negative political implications and is often referred to as what the former Finance Minister Michael Cullen described as "political suicide" (New Zealand Press Association, 2000, p. 1). The general view is that any political party introducing a CGT would lose the ensuing general election.

2.7 Conclusion

This literature review suggests that the current tax system is in need of a review, particularly regarding the issues surrounding the capital/income distinction and the extent to which capital gains are taxed. It appears that such a distinction might be a clear one for simple cases, but can be extremely difficult in other, border-line ones. The extent to which capital gains are taxed in the current tax system is heavily biased towards certain types of assets. For example, a taxpayer will be liable to pay tax on domestic shares that are acquired with the "dominant" purpose of resale, while he or she will pay accrual income tax on foreign shares (under the foreign investment fund regime), irrespective of the taxpayer's intention. The problem is that this situation creates tax arbitrages and provides an incentive for taxpayers to characterise an income as a receipt of a capital nature to avoid taxation.

In the last 20 years, many government tax inquiries had been established to investigate whether to expand the tax base to include more capital gains or to adopt a comprehensive CGT. However, the results have been mixed and uncertain. The latest 2001 McLeod Tax Committee opposed the introduction of a comprehensive CGT because of its administrative complexity. The committee considered a CGT system to be complex and more complicated to administer than were other taxes. It then suggested that the tax had posed significant problems to both the government and individual taxpayers as evident in both the UK and Australian CGTs. In these countries, CGTs were constantly subject to fierce public criticism because of complexity problems. It was argued that the complexity of the CGT provisions was due to its comprehensive broad coverage and a myriad of different types of tax relief provisions.

According to the various New Zealand Tax Committees, another major reason for not introducing a CGT was the low revenue yield. For example, the McCaw Committee (1982) came out against a CGT, stressing the "substantial complexity of the tax for little revenue" (p. 232). This stance was because a significant number of capital gains have already been covered by the current tax system. Moreover, it was argued that there were many tax deferral opportunities where taxpayers could delay the tax payment under a realisation-based CGT. Most importantly, the uncertainties over the application of the arbitrary distinctions between a realisation and a rollover might further complicate the deferral problem.

When drawing on the experience of other OECD countries, it is found that the findings of the New Zealand Tax Committees did not constitute the whole picture about the capital gains taxation in practice. In fact, when considering the introduction of a CGT regime, most OECD countries found that the advantages of a CGT generally outweighed its disadvantages and that a CGT could provide the benefits of: securing tax revenues; improving efficiency, strengthening the horizontal and vertical equity; encouraging savings and investment; and simplifying the tax system.

Despite these advantages, New Zealand is the only OECD country that does not have some forms of general CGT regimes in place. The existing tax provisions that charge capital gains are designed to be very specific. Such partial inclusion of capital gains by no means constitutes a comprehensive CGT. It is, therefore, important to consider the issue of taxing comprehensive capital gains in the wider context. In this respect, efforts have been made to look at a number of design issues in respect of the implementation of a CGT from a policy perspective. These issues include: (1) coverage of CGT assets; (2) realisation- versus accrual-based taxation; (3) treatment of the inflation component of capital gains; (4) selection of an appropriate tax rate; (5) treatment of losses; and (6) timing of realisation and rollover provisions. To demonstrate the different approaches in dealing with these issues, a brief review of the CGT systems in the selected OECD countries (namely, Australia, Canada, Ireland, the United Kingdom and the United States) is provided. These countries have tax systems that are designed to follow the principle of the Haig-Simons' comprehensive income. However, due to the variations in their individual tax systems, many differences are observed in the context of the overall tax outcome as well as its impacts on taxpayers in practice. Moreover, none of these countries has actually implemented an ideal comprehensive tax system which assumes that all types of income (e.g., labour income and capital gains) should be taxed on an accrual basis. In practice, the tax systems can only be characterised as having “semi-dual” tax systems (where capital gains are taxed at a lower, flat tax rate).

This study aims at exploring the key issues, aspects and attributes concerning CGT in New Zealand. This objective was achieved by looking at the issue of taxing comprehensive capital gains in the wider context. This study adopts the condensed version of Adam Smith’s canons of taxation, i.e., equity, efficiency, and simplicity, as the evaluation criteria for a good tax structure. At the same time, three major schools of thought, namely, the comprehensive income theory, the optimal tax theory, and the public choice theory, in regard to the design and reform of taxation are discussed. It is found that the divergence of tax theories can lead to conflict between the tax criteria used in tax design. The extent and nature of that conflict will depend upon which school of economic thought one belongs to. It, therefore, follows that a good tax design must consider all three schools of tax theories and strike a balance of synthesis necessary for future development of an equitable and efficient tax system that includes a CGT.

Chapter Three Methodology

3.0 Introduction

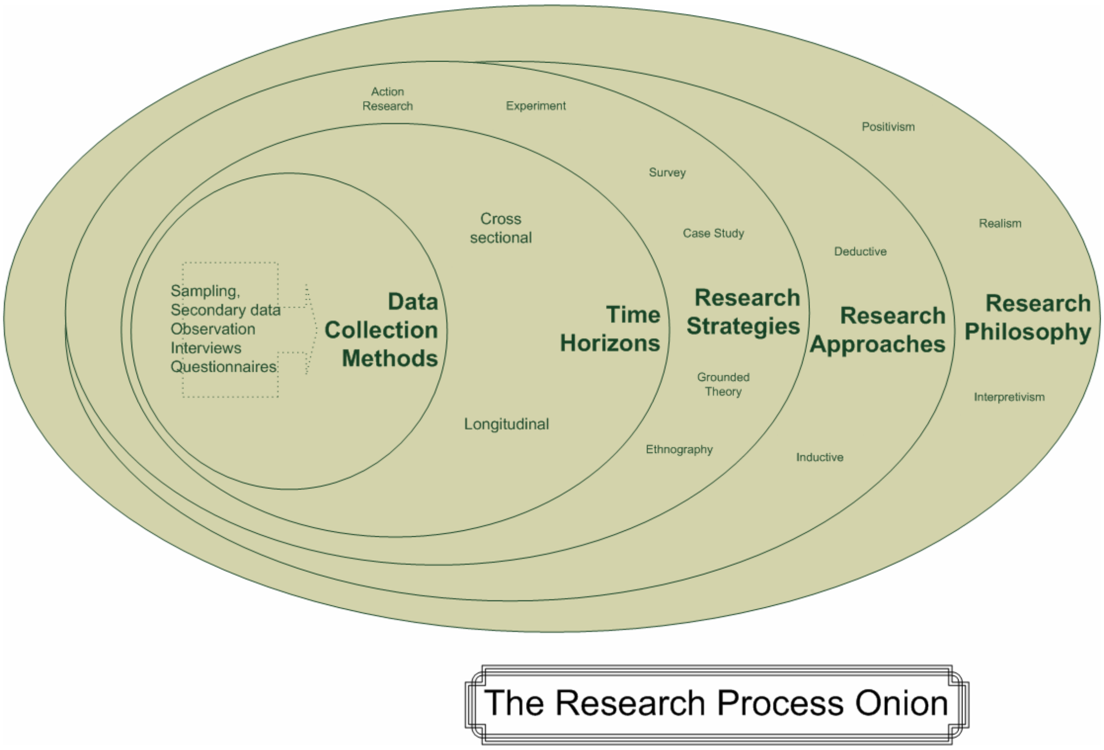
This chapter explains the research methodology and methods employed in this research project. Section 3.1 first provides an explanation of the research process by discussing the theoretical paradigms with their underlying philosophical assumptions for conducting research. Section 3.2 then presents the concepts of research methodology and reveals the main features of the quantitative and qualitative research paradigms. In section 3.3, a discussion of the mixed methods methodological approach is provided. This theoretical approach, which adopts both quantitative and qualitative research methods, provides the guiding principles and theories in developing the research strategies used for gathering the information to answer the research questions posed in this research. Sections 3.4, 3.5 and 3.6 will then provide a detailed review of the three phases of this research project.

3.1 Research Process

Research is “a process of planning, executing and investigating in order to find answers to our specific questions” (Ghauri & Gronhaug, 2002, p. 3). Many researchers attempt to explain the research process through the identification of the key elements for conducting research.

Saunders, Lewis and Thornhill (2000) described the research process as the research “onion” (see Diagram 3.1). In this research onion, different layers or questions needed to be considered in the development of the research process. They explained that the first layer of the onion “raises the question of the research philosophy you adopt. The second considers the subject of your research approach that flows from that research philosophy” (p. 84). The other layers of the onion focused on the research strategy, time horizon, and the data collection methods.

Diagram 3.1 The research onion



Source: Saunders, Lewis, Thornhill, 2000, p. 84

In the development of any research project, defining the epistemological position, theoretical perspective, methodology and method of a research project is vital. Crotty (1998, pp. 2 – 4) defined the four basic elements:

- Epistemology: the theory of knowledge embedded in the theoretical perspective and thereby in the methodology
- Theoretical perspective: the philosophical stance informing the methodology and thus providing a context for the process and grounding its logic and criteria
- Methodology: the strategy, plan of action, process or design lying behind the choice and use of particular methods and linking the choice and use of methods to the desired outcomes
- Methods: the techniques or procedures used to gather and analyse data related to some research question or hypothesis.

To elaborate the four elements further, Crotty provided a brief list of each category (as shown in Table 3.1).

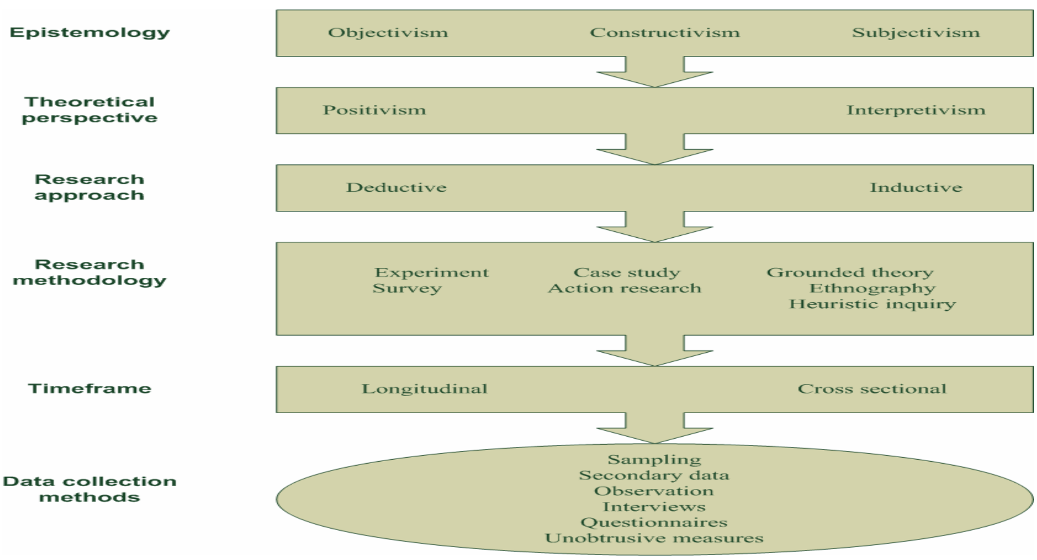
Table 3.1 Four basic elements of the research process

Epistemology	Theoretical perspectives	Methodology	Methods
Objectivism Constructivism Subjectivism (and their variants)	Positivism (and post-positivism) Interpretivism • Symbolic Interactionism • Phenomenology • Hermeneutics Critical inquiry Feminism Postmodernism, etc	Experimental research Survey research Ethnography Phenomenological research Grounded theory Heuristic inquiry Action research Discourse analysis Feminist standpoint research, etc	Sampling Measurement and scaling Questionnaire Observation Participant Non-participant Interview Focus group Case study Life history Narrative Visual ethnographic methods Statistical analysis Data reduction Theme identification Comparative analysis Cognitive mapping Interpretative methods Document analysis Content analysis Conversation analysis, etc

[Extracted from Crotty, 1998, p. 5]

A similar approach was adopted by Gray (2004). Two further elements i.e., research approach and time horizon were added to the research process put forward by Crotty. The ideas are represented graphically in Diagram 3.2.

Diagram 3.2 Elements of the Research Process



Extracted from Gray, 2004, p. 30

Mertens (2005) provided a discussion of the research process and paradigms, allowing researchers to identify a suitable research strategy. In her opinion, there were basic beliefs associated with each of the major research paradigms (such as positivism, constructivist, transformative and pragmatic). These basic beliefs would guide every decision made by the researcher and affect a number of aspects (such as the research method) during the research process. These basic beliefs are summarised in Table 3.2 below.

Table 3.2 Basic beliefs associated with the major research paradigms

Basic beliefs	**Positivism/ Postpositivism**	**Constructivist**	**Transformative**	**Pragmatic**
Ontology (nature of reality)	One reality: knowable within probability	Multiple, socially constructed realities	Multiple realities Shaped by social political, cultural, economic, ethnic gender, and disability values	What is useful determines what is true; participants perform reality checks by determining increased clarity of understanding
Epistemology (nature of knowledge; relation between knower and would-be known)	Objectivity is important; the researcher manipulates and observes in a dispassionate, objective manner	Interactive link between researcher and participants; values are made explicit; created findings	Interactive link between researcher and participants; knowledge is socially and historically situated	Relationships in research are determined by what the researcher deems as appropriate to that particular study
Methodology (approach to systematic inquiry)	Quantitative (primarily); interventionist; decontextualised	Qualitative (primarily); hermeneutical; dialectical; contextual factors are described	Inclusion of qualitative (dialogic), but quantitative and mixed methods can be used; contextual and historical factors are described, especially as they relate to oppression	Match methods to specific questions and purposes of research; mixed methods can be useful

Extracted from Mertens, 2005, p. 9

3.2 Methodology

It is important to look into the concept of methodology before laying out the research framework for this study. “Methodology” is defined as “the system of methods and rules to facilitate the collection and analysis of data” (Hart, 1998, p. 28). It is the “methods and procedures used by a science or discipline; the philosophical analysis of method and procedure” (Webster’s Universal Dictionary, 1993, p. 340).

Kandlbinder (2003) considered that methodology was “the underlying theory and analysis of how any research should proceed”. [It provided the] “guiding principles for determining, among other things, how to choose the techniques used for gathering evidence and why” (p. 1).

3.2.1 Research methods

The choice of methodology and design must be driven by the research purpose (Coll & Chapman, 2000). Traditionally, the most common ways to classify methods for undertaking research of human and social phenomena are into quantitative and the qualitative methods (Myers, 1997). In general, researchers in each category are involved in examining their own data sets and they adopt several specific research techniques (such as survey, interview, and historical analysis).

Both quantitative and qualitative methods have advantages and disadvantages. According to Firestore (1987), choosing an appropriate method is not “just a matter of coming at a single truth from different directions”. [The selected method should encourage one to adopt] “conventions of presentation that advance certain kinds of arguments for the credibility of one’s conclusions” (p. 20).

Drawing on the writings of many authors (e.g., Creswell, 1994; Denzin & Lincoln, 1994; Guba & Lincoln, 1994; Tashakkori & Teddlie, 1998), Neuman (2003) summarised the key differences between quantitative and qualitative styles of research. These are shown in Table 3.3 below.

Table 3.3 Comparisons of quantitative and qualitative research

Quantitative	Qualitative
Measure objective facts	Construct social reality, cultural meaning
Focus on variables	Focus on interactive processes, events
Reliability is key	Authenticity is key
Value free	Values are present and explicit
Independent of context	Situationally constrained
Many cases, subjects	Few cases, subjects
Statistical analysis	Thematic analysis
Researcher is detached	Researcher is involved

Source: Neuman, 2003, p. 16.

There are extensive methodological debates among the followers of each style of research regarding the appropriate application of the ontology (nature of reality) and the epistemology (the relationship of the knower to the known). Some researchers find it difficult to understand or appreciate the other style. For example, the traditional quantitative-style researchers claimed that their research was "real" social science (Levine, 1993), while the qualitative-style ones argued that their research would displace the outdated quantitative research approach (Denzin & Lincoln, 1994). These differences resulted in a period of heated debate. In some extreme cases, the debates were even referred to as "paradigm wars" (Gage, 1989, p. 4).

Notwithstanding the differences between quantitative and qualitative approaches, the reality of social research is that it does not fit neatly into either of the two categories. Hedrick (1994) argued that most of the approaches were in fact complementary and, therefore, the quantitative-qualitative debate was a "useless endeavour" (p. 45). In practice, the approaches are not mutually exclusive as researchers tend to use parts of both approaches. Moreover, although the approaches involve a different treatment of data types, they often share assumptions or have over lapping grounds. While the importance of research methods should be acknowledged, the methods should only play a facilitative role and should simply be regarded as “everyday work tools” (House, 1994, p. 20). Therefore, many now accept that the quantitative versus qualitative research methodological debate has been resolved (Creswell, 2003; Tashakkori & Teddlie, 2003).

3.3 Mixed methods methodology

A broad range of alternative approaches has emerged to widen the view of social science, seeking to overcome the artificial boundary between the quantitative and qualitative approaches. One of them is the ‘mixed methods’ approach (or the pragmatists approach). The pragmatists “use whatever philosophical or methodological approach works best for a particular research problem at issue” (Robson, 2002, p. 43). They believe that each of the quantitative and qualitative research approaches has its strengths and limitations, that the approaches are compatible and that the best research often combines the features of each (King, Keohane & Verba, 1994; Bryman, 2001; Kelle, 2006).

According to Tashakkori and Teddlie (1998), most good researchers prefer to address their research questions using a wide range of the methodological tools available, following the pragmatist credo of “what works” (p. 21). Therefore, the pragmatists emphasize that the particular methodology adopted for the research will be determined by the research question and the choice of paradigm. It also has implications for the choice of the research methods. As such, the pragmatists argue that for those who are committed to their research problem, methodology is secondary to the research question itself.

Mixed methods methodology involves the incorporation of both the quantitative and qualitative research principles “to answer research questions that could not be answered in any other way” (Tashakkori & Teddlie, 2003, p. x). Other researchers have used various terms to describe such a research approach. For example, it is termed as “multi-strategy research” in Bryman (2001), “multimethod research” in Brewer and Hunter (2006), and “multiple methods” in Robson (2002).

Although the term "mixed methods" research methodology has not been widely used in the area of taxation, there are a number of research studies utilising both the quantitative and qualitative principles and illustrating the usefulness of such an approach in the field of taxation (Evans & Walpole, 1999; Evans, 2003). The mixed method is generally applied to research studies with complex problems with a lack of simple paradigm solutions. Moreover, it has been used to examine organization structure and policy (Beene, 2001); management policy (Nadel, 2004); public hospitals' administration (Wilson, 2000), and ethical educational interventions (Low, 2007). The approach serves as an important tool in the development of reasoning for an exploratory study, particularly in the policy context. Tashakkori and Teddlie (2003) argued that "mixed methods research has evolved to the point where it is a separate methodological orientation with its own worldview, vocabulary and techniques" (p. x). They believed that such a research approach would become the dominant methodological tool in the social and behavioural sciences during the twenty-first century.

3.3.1 Mixed methods methodological framework

As stated in chapter 1, the objective of this study is to explore the key issues, aspects, and attributes concerning CGT in New Zealand to enable the formulation of policy guidelines that might be used if a CGT were considered in New Zealand. It is ideal to develop a theoretical tax model that is both worthy of vigorous public support, and informative in regard to the contemporary debate on the reform of the New Zealand tax system. However, the limitations of available resources and time make surveying all the key stakeholders (such as the taxpayers, tax practitioners, tax professional bodies, and tax administrators) impossible, and, therefore, this study is confined to exploring the central issues and concepts underpinning a possible CGT model by collecting opinions from a group of tax experts (i.e., tax teachers and tax practitioners). In that way, it was hoped to identify the potential strengths and weaknesses in different CGT models, and to seek to establish a consensus around one single CGT model. Moreover, the investigation would, to a certain extent, determine the levels of potential public resistance/acceptance by looking at the possible tax structure and the reasons behind the tax experts' adoption decision. The primary aim of this mixed method study was not to test or prove a theory, but rather to generate a theory through inductive logic.

A number of researchers have identified strategies in conducting mixed method research (Creswell, 1994, 2003; Greene, Caracelli & Graham, 1989; Patton, 1990; Tashakkori & Teddlie, 1998, 2003). Creswell (2003) suggested that all mixed methods could be grouped into three general strategies:

i. Sequential procedures: in which the researcher seeks to elaborate or expand the findings of one method with another method. The study may start with a quantitative method for proving or disproving various hypotheses followed by a qualitative method for an exploratory purpose. Alternatively, the researcher can first collect the data through an exploratory qualitative method and follow up with a quantitative method for generalising results to a population.

ii. Concurrent procedures: in which the researcher converges quantitative and qualitative data in order to provide a comprehensive analysis of the research problem. Various forms of data are collected at the same time and then are interpreted collectively using triangulation techniques.

iii. Transformative procedures: in which the researcher uses a theoretical lens as an overarching perspective within a design that contains both quantitative and qualitative data. In this design, the lens, which serves as a guiding framework for the study, helps researchers to formulate the topics of interest and methods for collecting data.

This study adopted the first mixed method strategy – sequential procedures as described by Creswell (2003). The research strategy, which involved both a qualitative and quantitative approach, was utilised to determine the extent of the tax experts' perceptions of a CGT in New Zealand and to capture a more complete understanding of the design of a CGT model, as well as the rationale for choosing it. An overview of the research process and the method used for this study are explained in the following section.

3.3.2 Overview of research process

Phase One: This research was started with a quantitative method – a questionnaire survey. In this phase, the survey instrument, which was based on the concepts of the Australian CGT system and other literature, was pre-tested and revised with colleagues in the Accounting Department. The questions in the survey were mostly closed (QUAN), with a space being provided for written feedback (QUAL). Data were first collected from a small group of tax experts, i.e., New Zealand tax teachers (or academics). After collecting most of the completed questionnaires from the respondents, the researcher revised the survey instrument for use exclusively with the larger group of tax experts, i.e., tax practitioners throughout New Zealand.

Data were then aggregated to form a single base of tax experts for compiling a statistical analysis. The tax experts' overall perceptions of a CGT model were identified by summarising all the responses to the survey instruments. Two major groups of tax experts were then identified, namely, the CGT proponents and the CGT opponents. This delineation was used to examine factors that affect tax experts' attitudes to a CGT model by comparing their opinions. Understanding these factors could also extend the existing knowledge on their attitudes to the implementation of a CGT.

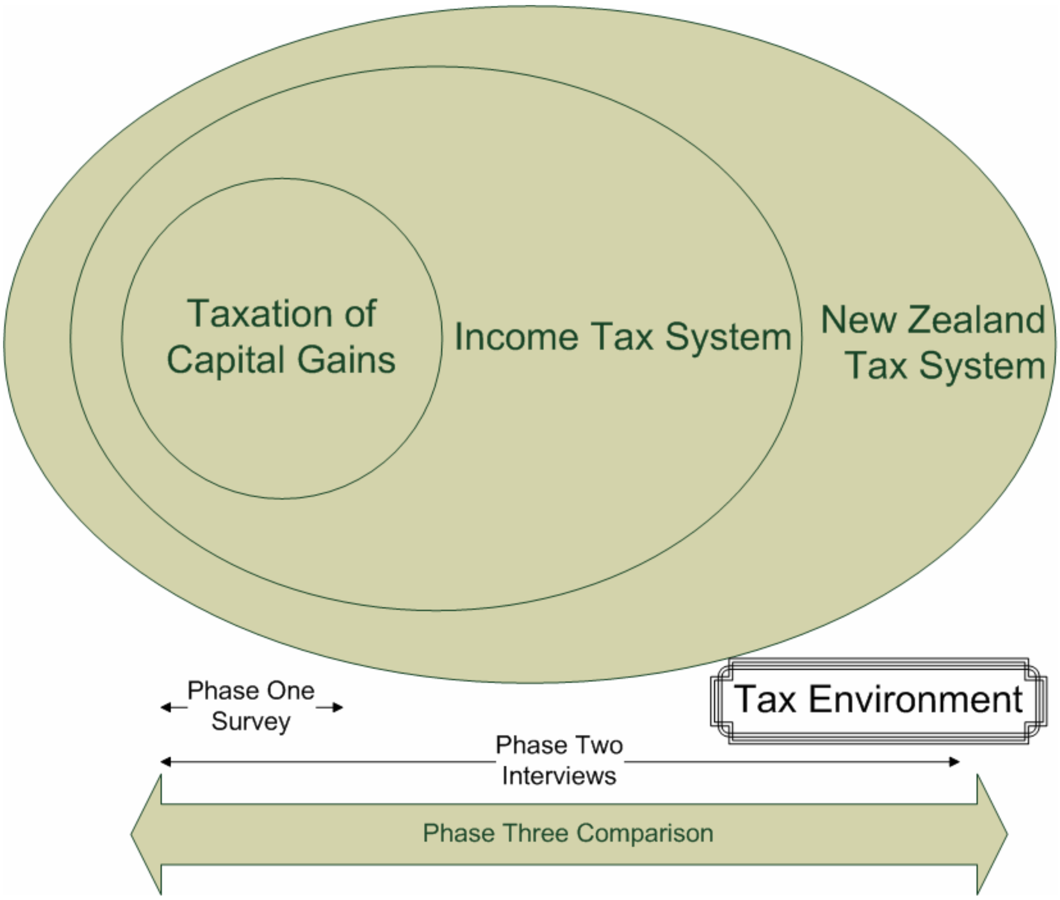
Phase Two: The phase involved interviewing the tax experts. A limitation to the questionnaire method was that it did not provide in-depth information for measuring attitudes, as face-to-face interviews would (Johnson & Turner, 2003; Patton, 2002). For this reason, a face-to-face, individual, semi-structured and open-ended interview instrument was chosen for the study. Respondents to the main survey were invited to participate in the follow up interviews. While the follow-up interview played an important role in data collection, as it could capture the tax experts' experience as described in a first person account, the interview data would provide an in-depth understanding on a tax expert's experience, thus enabling the researcher to undertake a comprehensive review of the tax system. This approach also enabled the researcher to gain a deeper understanding through the viewpoint of the actual participants (Lincoln & Guba, 1985).

It was noted that all written feedback and the remarks made by the respondents in the questionnaires in Phase One were also used in the qualitative analysis. This material included the written feedback received from the non-participating tax experts who were not willing to complete the survey but yet had expressed an opinion on the research topic. All data sources were then triangulated using the NVivo software.

Phase Three: Finally, once the main themes and adoption factors had been identified in the Phase Two, they were compared with the results of the survey instruments in the Phase One in order to see if there was any compatibility between the results. The final results would provide a basis for discussion about the tax experts' overall views of a comprehensive CGT and the factors in relation to their decision making in the CGT adoption.

As discussed in chapter 2, despite the lack of a comprehensive CGT in New Zealand, various provisions of the Income Tax Act have been designed to tax income from specific capital gains transactions. In order to construct a CGT model, the three phases of this study explored the extent to which capital gains were taxed and identified the asymmetries of the current income tax system. It also considered the effects of other taxes (such as the Goods and Services Tax and the Fringe Benefits Tax), and factors influencing the tax environment (such as cultural, political and social factors), which would play an important role in the tax expert's CGT adoption decision. Diagram 3.3 provides an overview of the three research phases of this study regarding the investigation of the taxation of capital gains.

Diagram 3.3 The three research phases



It is recognised that the design and structure of the final CGT model are only frameworks towards understanding of the issues surrounding tax experts' attitudes to the taxation of capital gains in New Zealand. The model is a reflection of the tax experts' divergent opinions on the behavioural response of corporates and individuals to new tax policies. Generally, the study of a finite number of tax experts will not reveal the opinions of all the tax experts in the community. However, it will result in the identification of a number of important themes and tax issues that can be built on and expanded by other researchers. Moreover, the Government will be able to take heed of this framework and, if found appropriate, apply it in formulating better tax policies.

In summary, the theoretical framework for the mixed methodologies is graphically represented in Diagram 3.4. A more detailed flowchart of the research cycle is found in Diagram 3.5.

Diagram 3.4 Outline of methodological design

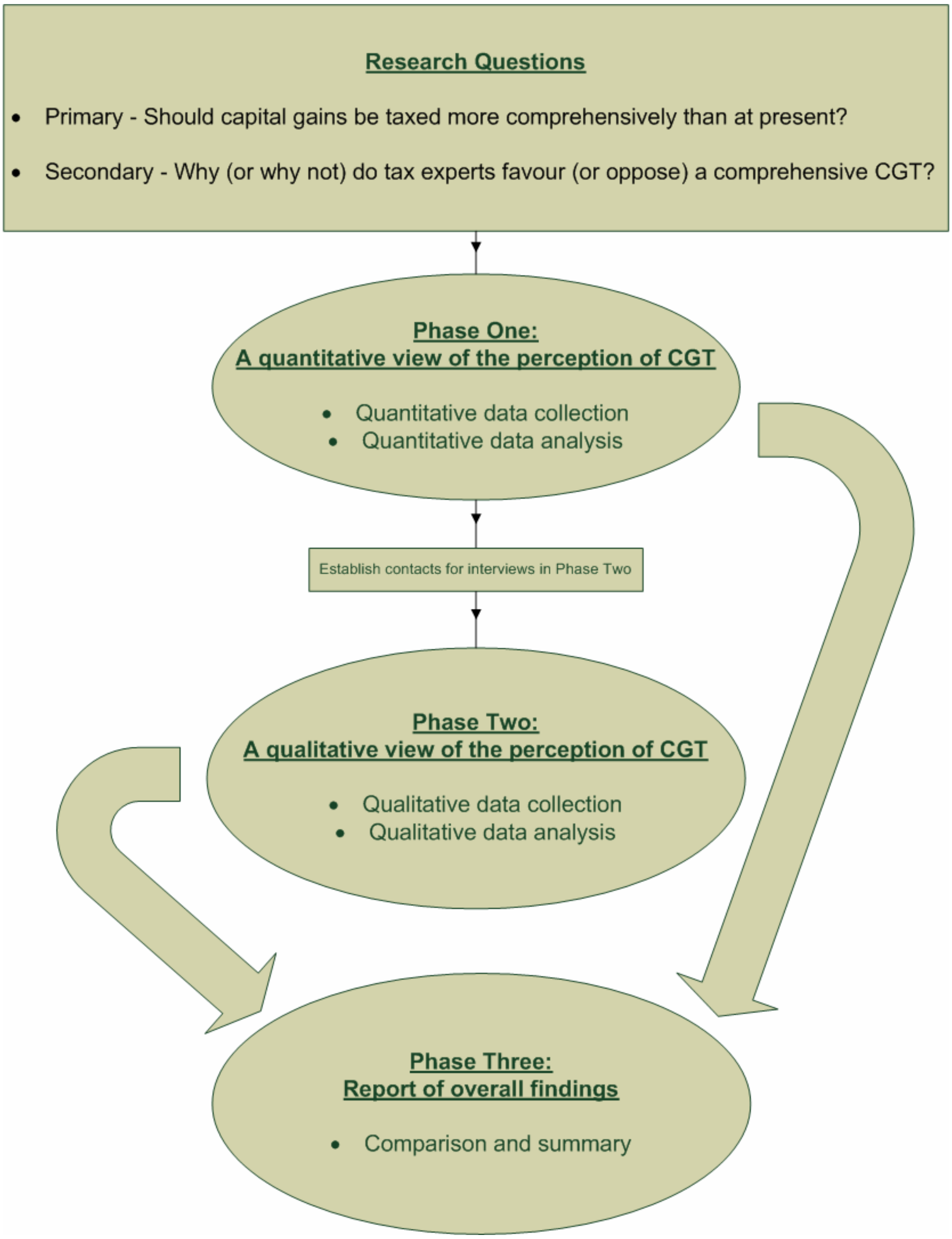
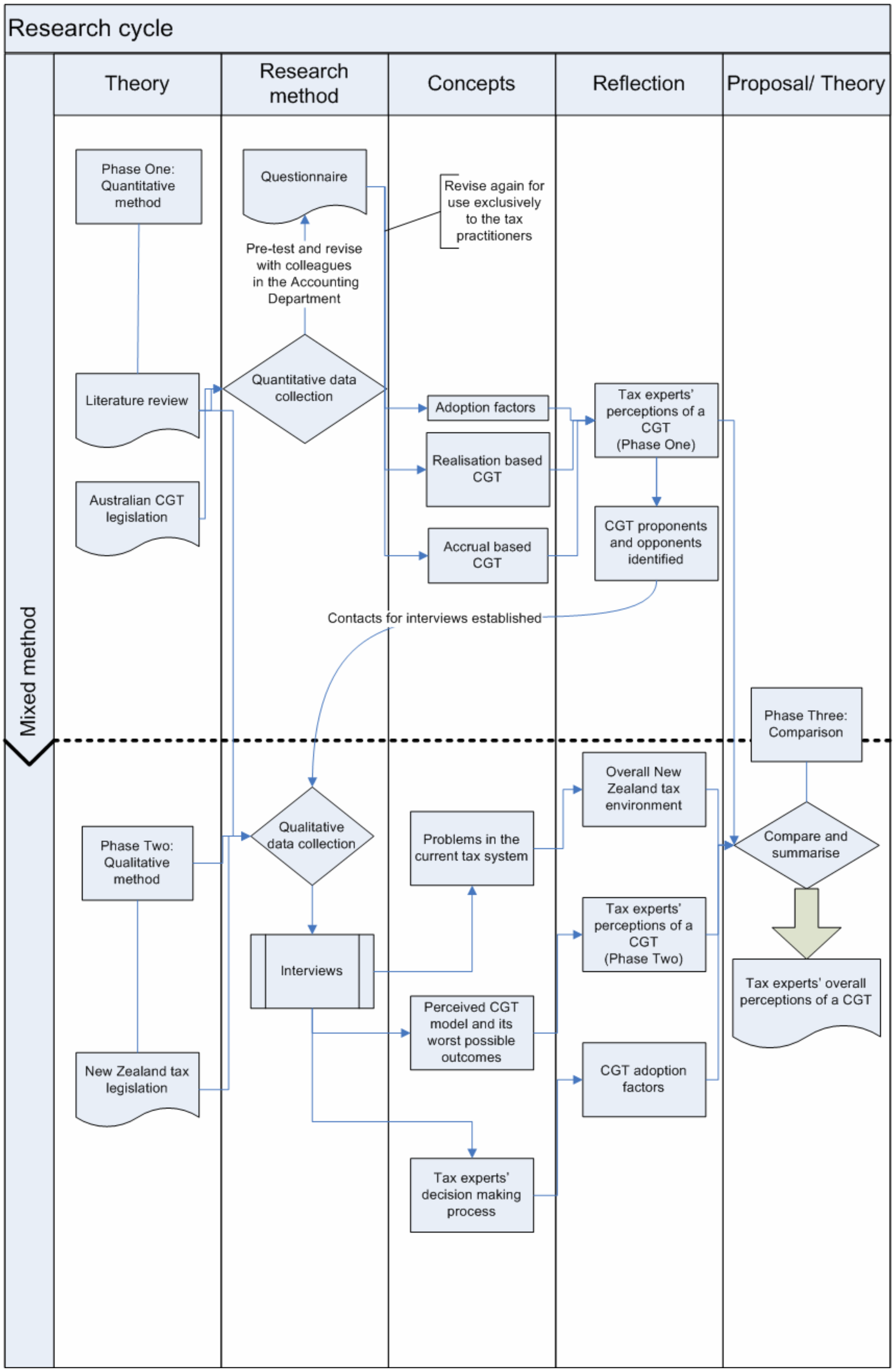


Diagram 3.5 Overview of research cycle



3.4 Phase One – Quantitative method

The purposes of this phase of research were:

- to build a preliminary framework of a CGT model.
- to identify certain factors that may affect tax experts' attitudes to a CGT model.
- to compare the opinions expressed by the CGT proponents and opponents.
- to establish contacts for interviews to be conducted in the Phase Two.

3.4.1 Sample frame

The survey was targeted at tax experts who had good knowledge of the New Zealand tax system. Although its scope was purposely limited to only tax teachers, tax accountants, tax agents and tax lawyers who all had working experience in tax practice for 3 years or more, it was still difficult to identify such a population, particularly on-the-job tax practitioners. In New Zealand, there is no single dominant professional body monitoring the practice of tax consultancy. Most of the tax return filing work for individuals is done by registered tax agents, who give both taxation and non-taxation advice to their clients. However, to provide tax consultation or tax return filing services, it is not compulsory to register as a tax agent with the Inland Revenue. Another major group of tax practitioners are accountants and lawyers. It is common for chartered accountants and legal practitioners to give tax advice to their clients as part of their on-going accounting/legal services. It is noted that the tax agents and the chartered accountants have different key areas of focus. The tax agents generally focus on tax consultancy for individuals and small-medium size businesses, while the Chartered Accountants and legal practitioners, especially the Big Four (namely, Ernst & Young, Deloitte & Touche, KPMG, and PricewaterhouseCoopers), specialise in the provision of accounting/legal (including tax consultation) services to large corporate clients.

To obtain the sample frame of tax teachers, a list of 51 tax experts who were working or had been working at the tertiary education sector was drawn from the Wiley Directory of Accounting, the Internet, personal contacts and by word of mouth from colleagues and friends.

Approval was sought and obtained from the ethics committee, prior to administering the survey (See Appendix B).

Before approaching tax practitioners, a cover letter first sent to professional bodies such as the Taxagents' Institute of New Zealand[44] and the New Zealand Institute of Chartered Accountants, to seek an endorsement of the study and the contacts for the tax practitioners for the purposes of distribution of the questionnaire. Although the professional bodies rejected an official endorsement, they did supply the web address for their databases which held their members' profile in the Internet at that time, i.e., website of the Taxagents' Institute of New Zealand, and the search engine at the New Zealand Institute of Chartered Accountants' website (which was run by a Yellow Pages server). These databases were freely accessible to the public and designed to help potential clients to search for tax agents. Another source of data for constructing the sample frame was the email contacts obtained via the websites of major accounting and law firms in New Zealand namely, KPMG, Deloitte, PricewaterhouseCoopers, Ernst & Young, BDO Spicers, and Chapman Tripp. The individuals were selected based on their title and/or interest in taxation. As a result, a list of 507 tax practitioners' contacts was developed.

In total, a database of 551 tax experts (i.e., 51 tax teachers and 507 tax practitioners) was constructed. The data were stored using Microsoft Excel. Subject to availability of information, the fields in the database included:

- Identification number (for internal use and only known to the researcher)
- Name of tax expert
- Gender
- Name of institution/organisation

[44] The TaxAgents' Institute of New Zealand (TINZ) is an independently incorporated society established in 1976. The aim of the organization is to foster the practice of Tax Consultancy in New Zealand. In order to become a qualifying member, one must have a degree with an accounting major or equivalent qualification, and has completed a tax unit as part of that course. Along with the degree, there is a requirement of a minimum of three years working experience in taxation practice. The TINZ Web site provides links to a variety of useful resources about the professional body (http://www.tinz.co.nz).

- Professional qualification
- Postal address
- Contact phone number and/or email address

3.4.2 Questionnaire design

Rather than attempting to generalise results, the objective of this study was to identify the tax issues that were vital in each tax expert's CGT adoption decision. Therefore, the intention of the survey was to identify and measure the tax experts' attitudes about certain aspects of the design of a CGT system, and to seek their views about the general CGT issues that surrounding the taxation of capital gains in New Zealand.

Since data about the tax experts' attitudes to the CGT issues was not available in any published or other form, the 31 questions in the survey were designed to answer the unasked questions in the previous literature. Also they were a reflection of the primary (and to a certain extent to the secondary) research question, i.e., whether capital gains should be taxed more comprehensively than at present. Most of the questions were closed-ended, requiring respondents to choose from a range of predetermined answers. In general, the responses to most of the questions were offered on a five-point ordinal Likert scale ranging from "strongly disagree to strongly agree". This design meant the busy tax experts to be able to finish the questionnaire within 30 minutes. Table 3.4 below provides an overview of the structure of the survey instrument.

Table 3.4 General structure of the survey instrument

Issue No.	Tax issues to be explored	Related survey questions
1	General CGT issues	Part 1
2	CGT assets (realisation basis)	Part 2 Question1-1
3	CGT events (realisation basis)	Part 2 Question 1-2
4	Indexation and tax relief	Part 2 Question 1-3 (1,3-6) Part 3 Question 8 and 9
5	Accrual CGT	Part 2 Section 2
6	Calculating a capital gain or loss	Part 3 Question 4
7	Tax rates	Part 3 Question 3
8	Capital losses	Part 3 Question 6 and 7
9	Other practical issues	Part 3 Question 10 to13

The tax issues and the design of the tax measures were mostly borrowed from the Australian CGT system. The harmonisation process between New Zealand and Australian had been seriously advocated by both governments and CGT was often the main item of distinction between the two countries' tax systems. However, it was also acknowledged that there were also fundamental differences between the two tax systems (Cheng, Hooper & Davey, 2000) and therefore additional tax issues from other countries such as the UK and Canada were also included in the questions.

3.4.3 Modification of the practitioners' survey

This research study was begun with an intention to design a CGT that could be applicable in the New Zealand environment. However, after receiving most of the completed surveys from the tax teachers, the author gradually realised from the written feedback in their survey response that many of them felt that they had not been given enough choice for the selection of the tax measure. Most importantly, many of them favoured the status quo and preferred amendments to the current legislation rather than a major revision of the current system. As a result, modifications were made to the survey questions in order to encompass this new notion. These amendments and the reasons behind them became the core category of the practitioners' survey (which involved a much larger group of tax experts).

Although efforts had been made to improve the readability of the questionnaire by pre-testing the survey instrument with colleagues in the Accounting Department, the wording of its specific parts might have been ambiguous to some tax teachers. Therefore, modifications were made to the survey and these included a new, first section for background information, a new question 3-1 about the level of support for a CGT, and some minor design changes to the questions about CGT assets and the treatment for an accrual-based CGT.

In the background information section of the questionnaire, the respondents were asked to provide their name, the name of their organisation, their professional qualifications, the types of speciality they were practising, and the number of years they had been engaging in tax practice. This section had been omitted for the tax teachers because it was assumed that they normally had professional qualifications and/or a doctoral degree, and had reasonable knowledge about CGT.

The new question 3-1 sought the practitioners' level of support for retaining the status quo, or for introducing a realisation-based capital CGT or an accrual-based CGT (based on a five-level Likert scale) to assess the CGT adoption decision. This question was the heart of the survey. As discussed earlier, its inclusion was a reflection of the results found in the tax teachers' written responses, i.e., that many of them favoured maintaining the status quo instead of introducing a CGT. In other words, a number of them favoured the traditional ad hoc approach to development of the tax system through incremental tax law amendments.

Copies of the covering letters and the two questionnaires used to survey the tax teachers and tax practitioners are found in Appendix C (tax teacher) and Appendix D (tax practitioner).

3.4.4 Sampling method

The application of the mixed method strategy meant that the success of the study depended upon the number of responses received in the survey. The more completed questionnaires received, the chances of getting the follow-up interviews with the tax experts would increase. Questionnaires were distributed to all tax experts on the list in order to maximize the opportunity for a follow-up interview. While the sample frame was not randomly drawn, it was important to emphasise that the targeted samples were not convenience samples (Fraenkel & Wallen, 1990). The complexity of a CGT and the lack of such a tax in New Zealand could mean that many tax experts might have had little or no exposure to CGT issues. It was, therefore, difficult to identify a specific tax expert who had exposure to, and reasonable knowledge of, the CGT.

The sample frame was likely to be broadly representative to the overall population of tax experts in New Zealand because 1) The distribution of the sample population was fairly spread across New Zealand and represented the demographic composition of the country; 2) The sample comprised lecturers, accountants and lawyers actively practising in the field of taxation; and 3) The sample frame represented a broad cross-section of the tax consultancy industries with practitioners coming from small sole practitioner tax agents through to medium-sized businesses to partners/employees of major accounting and legal firms.

3.4.5 Questionnaire response rate

The survey questionnaires were sent out with a personalised covering letter to two different groups of tax experts, i.e. the tax teachers and the tax practitioners, in the period between 25 August 2004 and 30 November 2005. In total, 558 questionnaires (507 completed by tax practitioners and 51 by tax teachers) were distributed, and 200 (170 tax practitioners and 30 tax teachers) were received. However, 23 (i.e. 21 tax practitioners and 2 tax teachers) returned a blank questionnaire for various reasons, for example, family problems, insufficient time, retirement, incompetent knowledge and skill, or reluctance to complete the questionnaire. The feedback from those who had returned incomplete questionnaires was included in the qualitative feedback analysis in chapter 5. Out of the remaining 177, another 2 completed questionnaires were not used because the practitioners had working experience in practising taxation for fewer than 3 years. As a result, 175 completed surveys were used for data analysis. Of the respondents, 84% were tax practitioners (n=147) and 16% were tax teachers (n=28). The overall response rate was 31.4% (175 out of 558).

A 31.4% response rate was considered a satisfactory one when compared with similar surveys in the field. A large postal survey (with a sample size of 16,000) conducted by the Inland Revenue achieved a 29% response rate (Oxley, 1993). Evans (2003) surveyed 667 tax experts in Australia and the United Kingdom, with a 29% response rate. A survey of 600 small businesses conducted by Arthur Andersen & Co (1985) achieved just a 7% response rate. Despite the relatively good response rates achieved in the survey, responses were tested for non-response bias. The results are discussed in the following section.

3.4.6 Response bias

Of the responses received from the tax practitioners in New Zealand, 76.2% (n=112) came from the North Island and 23.8% (n=35) from the South Island. It was also noted that lower than average responses were received from the Canterbury region. This lower number of responses could potentially distort the quality of the data provided by respondents. It was, therefore, important to check if any distortion did in fact occur, i.e., if there was a difference in levels of perception of a CGT across different regions. A Chi-Square test and a Kruskal Wallis test were conducted to analyse whether the respondents from different locations had produced equal response. The Kruskal Wallis test is a non-parametric test to provide one-way between group analysis of variance. It is similar to the Chi-Square test for independence, but it allows a comparison of some continuous variables for three or more groups.

The Chi-Square test was used to examine whether a dichotomous factor i.e., location -North Island and South Island, was significant in CGT adoption decision in question 1-1. This question asked the respondents to specify the types of asset (out of 15 classes of asset) that "should be included for CGT purposes". Two asset classes, Farm ("farm") and Private home ("home") were considered for the purpose of the test. The geographical location of the respondents would have a potential effect on the CGT adoption decision for these two assets if response bias did occur. Table 3.5 displays the result.

Table 3.5 Chi-Square test on geographical locations (two categories: North Island and South Island)

CGT Assets	Value	Df	Asymp. Sig. (2-sided)	Null hypothesis	Comment
Farm	0.085	1	.771	Accepted	No non response bias
Private home	0.002	1	.968	Accepted	No non response bias

As Table 3.5 indicated, the chi-square value was 0.085, p= 0.771 for Farm and 0.002, p= 0.968 for Private homes. With the level of significance established at p<0.05, the p values for these CGT assets were well above 0.05 and, therefore, the null hypothesis was accepted.

For the purpose of the Kruskal Wallis test, a category factor “region” (with 11 categories of location) and two factors of continuous variables were chosen: (a) the total attitude score for the perceived level of support to introduce a CGT (TCGT) and (b) the total attitude score for the general CGT issues (Gscore). These two measures (TCGT and Gscore) were used to test the non response bias, and the Kruskal Wallis test was used to examine whether the level of support of a CGT and the total attitude score were significantly different across the 11 major regions in New Zealand. With the level of significance established at $p<0.05$, the p values for these two factors were above the 0.05 level, and so the null hypothesis was not rejected. Therefore, there was no distortion in the regions, as shown in Table 3.6.

Table 3.6 Kruskal Wallis test on region in relation to total CGT support and total perception score

	Chi-Square	Df	p-value Asymp. Sig.	Null hypothesis	Comment
TCGT	17.633		.061	Accepted	No non response bias
Gscore	12.626	10	.245	Accepted	No non response bias

3.4.7 Data analysis

Survey instrument data were analysed using descriptive statistics. Also statistical tests (such as Chi-square) were computed to compare the CGT proponents’ and opponents’ responses. All the tests were computed using the computer software – SPSS, which is widely used in social sciences, particularly for taxation studies (Long & Parker, 1991; Field, 2005).

Different approaches were used to identify the CGT preferences of different groups of tax experts. The researcher asked the tax teachers to indicate their preference of a CGT model (i.e., a comprehensive CGT, the status quo or no preference) at the beginning of the interview, and reconfirmed the choice with them again at the end of the interview. This information was then recorded in each interviewee’s completed questionnaire.

The process was slightly different for the tax practitioners. Since each tax practitioner's choice of a CGT model had been specified in the questionnaire, the researcher first double-checked the choice with them during the interviews. This checking might happen at the beginning or in the middle of the interview. The researcher then reconfirmed their adoption decision at the end of the interviews.

3.5 Second Phase – Qualitative method

The purposes of this phase of research were:

- to provide an in-depth understanding on a tax expert's experience.
- to undertake a comprehensive review of the tax system in general terms.
- to define the phenomenon of capital gains taxation.
- to establish a taxonomy of factors that influenced the tax experts in the CGT adoption decision.

3.5.1 Qualitative interviewing

Qualitative interviewing comes in many forms. The two most common types are unstructured and semi-structured interviews (Bryman, 2001). They can be conducted by face-to-face, by telephone, through video conferencing technology, or other online communication tools (such as instant messenger).

This study adopted an individual face-to-face, standardised semi-structured and open-ended approach to interviewing. The approach was particularly useful as it assisted the researcher in finding out information that was not available in the surveys. In particular, the individual face-to-face interview provided an in-depth understanding of the meanings that the tax experts held for capital gains taxation. It also allowed the clarification of any ambiguous or unclear questions which might have been misinterpreted by them in Phase One.

A semi-structured form was chosen for the current study because of this method's particular strength in ensuring cross-case comparability (Bryman, Haslam, & Webb, 1994; Bryman, Gillingwater, & McGuinness, 1996). With this form of interviewing, the interviewing process was systematic and comparison between cases became easier as each tax expert's answer to the same question could be quickly located and organised. Moreover, interviewer effects and subjectivity were minimised as each participant was asked the same questions. Thus, the necessity for interviewer judgement during the interview was reduced.

All questions in the interviews were designed to be open-ended which allowed the participants to express their thoughts and feelings in detail (Patton, 2002). However, the open questions were not without their limitations. They often required greater effort from respondents and were more time-consuming and expensive for both data collection and analysis. To get over some of these problems, the researcher had to prepare an interview guide, which is a list of questions or fairly specific topics to be covered in the interviews. It allowed the researcher to ensure that the limited interview time was best used to cover the research issues.

A review panel was first conducted to help determine the nature and form of actual interview questions. A semi-structured interview guide was built based on previous literature and the findings of the quantitative survey in Phase One. Five open-ended questions exploring major anomalies in the tax system and suggestions for improvement to these anomalies were developed. The interviewees were also asked to identify the central or primary considerations they factored into the policy decision on whether and how to tax comprehensive capital gains in New Zealand.

3.5.2 Before the interviews

Phase Two commenced after the participants in first phase were invited at the final part of the survey to participate in the follow up interview. Ethical approval was required because these interviews involved human participants. In this regard, the researcher had applied for ethical approval for administering the interview questions and format.

Upon agreeing to take part, each participant was sent a covering letter (Appendix E) which outlined the purpose of the interviews and interview arrangements in terms of date and location. All of the participants were assured that all information would be confidential. The covering letter also included the contact details for the researcher and his supervisors, should participants have any concerns or questions regarding the study. The participants replied to the researcher through either email or letter mail enabling the researcher to set a date and time and the venue for the interviews. Interview questions were sent to the participant beforehand if requested.

3.5.3 Conducting the interviews

All interviews were conducted at the tax experts' premises. After thanking the participant for his or her participation in the study, the researcher first obtained the signed consent form, which was required by the ethic committee. Then the researcher reminded participants of the contents of the covering letter and confirmed if it was still acceptable to record the discussions using a digital voice recorder.

During the interviews, most of the tax experts were friendly and very open in attitude. However, they were cautious about discussing sensitive information such as the names of their clients and any questionable positions in the clients' tax returns. In some cases, they asked the researcher to switch the digital recorder off as they wanted to express views they did not wish to have recorded.

On average, each interview lasted 90 minutes. Although the interview guide was followed for each interview, it was developed further with participants as new ideas were generated during individual interview. Ideas from previous interviews were re-examined and more themes emerged as the interviews progressed.

In total, there were 33 interviewees (i.e., 20 tax practitioners and 13 tax teachers), thus representing 19% of the 175 who responded the questionnaire survey. The majority were male, 82% (n=27), and 18% (n=6) were female. The geographical locations of the tax experts represented a spread across the north and south islands of New Zealand i.e., from Keri Keri (northern New Zealand) to Invercargill (southern New Zealand); and from Greymouth (south-western New Zealand) to Tauranga (north-eastern New Zealand). All interviews were conducted in the period between 7 December 2004 and 28 April 2006.

3.5.4 Transcribing the interviews

The digital audio CD-ROMs for the interviews were transcribed by a third party professional interview transcription business. To protect the confidentiality of the participants, the researcher first edited the content of the interviews so that all sensitive information was erased before sending the disc to the business. The researcher also double-checked the transcripts to ensure they were correct. After undergoing all the review processes, complete transcription summaries were sent to three randomly selected participants in order to confirm whether or not the transcriptions represented their views.

3.5.5 Data analysis

All the transcripts were coded using a combination of manual and computer aided methods. Computer software – Nvivo was used to develop categories of coding and analysis. Initially, there were 93 nodes (or codes) in respect to the tax experts' perception about the current tax environment and the design features of a CGT model. At the end, these codes were merged into several themes of the study. The analysis will be discussed in greater detail when discussing the results in chapter five.

3.6 Phase Three – Comparison of findings

The purposes of this phase of the research were:

- to compare and validate the findings from survey instruments and the interview data.
- to investigate the reasons behind the tax experts' CGT adoption decision.
- to identify a number of important policy considerations and review their implication for the adoption of a CGT in New Zealand

Phase Three of the study involved the comparative analysis of survey and interview data concerning the taxation of capital gains. This stage utilised triangulation techniques which enabled the researcher to cross-check findings derived from both quantitative and qualitative research as the trustworthiness and authenticity of the study could be enhanced by the compatibility of the two findings.

However, it was possible that some of the findings might fail to corroborate. The seemingly contradictory findings might exemplify the factors that led to the adoption of a CGT model and would result in greater understanding of the phenomenon (Greene et al., 1989). As such, further analysis would be needed to address the inconsistency.

At the final part of Phase Three, the researcher presented the overall findings with a revisit of relevant literature. The aim was to identify a number of important policy considerations and to review their implication for the adoption of a CGT in New Zealand.

3.7 Summary

The complexity of CGT was mirrored in the complexity of the research approach employed to explore it. Given the exploratory nature of this research study, the data provided by both the quantitative and qualitative approaches generated a rich seam of information relevant to the overall research objectives. The essence of the mixed method methodology meant that new ideas were being captured and triangulation analysis of the data became a continuing and evolving process within the research cycle.

This study utilised both a quantitative and qualitative research approach to explore the factors that are related to tax experts' attitudes towards a particular measure of a CGT model (i.e., current approach, a realisation-based CGT or an accrual-based CGT). It was an attempt to capture a more complete understanding of certain specific tax issues and measures (e.g., tax planning, main residence exemption, adjustment for inflation, etc) that were vital in the tax experts' CGT adoption decision process. The quantitative findings are revealed in Chapter 4 and the qualitative ones are explored in Chapter 5. These findings are then triangulated to inform the discussion of key CGT issues in Chapter 6.

Chapter 4 A quantitative view of the perception of CGT

4.0 Introduction

This chapter reports the findings in the tax teacher and tax practitioner surveys. The objective is to identify the components of a construct and subconstructs through analysis of the quantitative data. In Chapter 6, the quantitative results will be compared with the qualitative data in order to validate the categories or to expand the information that was available regarding these subconstructs.

Section 4.1 below provides information about the respondents' backgrounds. Then Section 4.2 reveals the perception of general CGT issues. Sections 4.3 to 4.8 report the findings for each of the major components of a theoretical CGT model with a comparative analysis showing the main similarities and differences in the attitudes of both CGT proponents and opponents. Section 4.9 summarises the overall tax experts' perceptions and the results of the comparative analyses. Section 4.10 provides a review of the important policy issues about the tax expert's adoption decision, and concludes the findings of the quantitative analysis.

4.1 Background information

Data from 175 completed surveys were used for data analysis. The respondents comprised tax practitioners and tax teachers. Tax practitioners made of 84% (n=147) and 16% were tax teachers (n=28).

Of the total 147 tax practitioners, over three-quarters were male, i.e. 77% (n=113), and the rest female, i.e. 23% (n=34). Table 4.1 reveals the geographical locations of respondents.

Table 4.1 Number of tax practitioners by region

Region	Frequency	Percent
Auckland	45	30.6
Bay of Plenty	5	3.4
Gisborne/Hawkes Bay	9	6.1
Northland	6	4.1
Waikato	8	5.4
Wanganui/Manawatu	16	10.9
Wellington/Masterton	23	15.6
Canterbury/Christchurch	10	6.8
Otago	7	4.8
Southland	12	8.2
West Coast/Nelson/Marlborough	6	4.1
Total	147	100.0

Table 4.2 shows the minimum working experience of the tax practitioners was 3 years. Most of them were registered tax agents. The reminder were members of the New Zealand Institute of Chartered Accountants, Certified Public Accountants, members of the Taxation Institute of New Zealand and members of the New Zealand Law Society. Also two thirds had working experience in practising taxation for more than 10 years.

Table 4.2 Professional qualification and level of working experience of tax practitioners

	Professional qualification				
Years practising in taxation	Chartered Accountants	Registered Tax Agents	Both CA and TINZ	Other (CPA, lawyers)	**Total**
3 – 10	7	27	2	3	39
11 – 15	14	17	2	1	34
16 – 19	5	11	4	1	21
20 – 25	10	12	2	2	26
26+	6	17	3	1	27
Total	**42**	**84**	**13**	**8**	**147**

For the 28 questionnaires completed by tax teachers, 20 of these teachers were based in the North Island and 8 in the South Island. Twenty-Four were full time lecturers/professors while 4 were part-time lecturers practising in tax at that time.

Seventeen were males (60%) and 11 (40%) were females. As mentioned in the methodology section in Chapter 3, the tax teacher survey did not gather information about the participants' level of support for, or against, the introduction of a comprehensive CGT system. In order to compare the attitudes of CGT proponents and CGT opponents, the statistical comparison data for tax teachers were confined to the results gained from the 13 interviewees who had expressed their support for or opposition to the introduction of a CGT. The demographics profile of tax teachers is contained in Table 4.3 below.

Table 4.3 Background of tax teachers

	Survey	**Interview (for the purpose of the comparison between CGT proponents and opponents)**
No. of respondents	28	13
Gender		
Male	17	11
Female	11	2
Institution		
University	20	11
Institute of Technology	8	2
Location		
North Island	20	11
South Island	8	2
Employment		
Full-time	24	12
Part-time	4	1
Introduction of a CGT		
Support	n.a.	4
Neutral/ Uncertain	n.a.	1
Oppose	n.a.	8

4.2 General perception of a CGT

4.2.1 Survey result for CGT adoption decision

This section looks at the respondents' general perception of a CGT, particularly, their level of support for the status quo tax system, a comprehensive realisation-based CGT, or a comprehensive accrual-based CGT.

For the 147 tax practitioners, they strongly supported the status quo tax system with a median score of 5, a mode of 5 and a mean of 4.1. They were neutral about a comprehensive realisation-based CGT (median, 3, mean, 2.8 and mode, 1). It was also clear that they strongly disagreed with an accrual-based CGT with all statistics scores of about 1. It is important to note that section 3-1 of the practitioner questionnaire (which looked at the level of support for the status quo and CGT) had a high non response rate (14% for status quo tax system, 18% for a realisation-based CGT and 27% for an accrual-based CGT). The tax practitioners appeared somewhat confused about the design of the questions. They might mistakenly have though that the three sets of tax models were mutually exclusive, that is, the occurrence of one is incompatible with the occurrence of the other (three tax models cannot happen at the same time). Completing only one part of the question and leaving the other two blank, many respondents treated the questions as a dichotomous Yes/No statement. However, both events can actually co-exist (mutually inclusive). The logic behind this argument is that it is possible one might possibly be unsatisfied (with a low level of support) with the status quo tax system while still opposing a CGT (with a low level of support to both CGT models).

The result was summarised in Table 4.4 (a).

Table 4.4 (a) Level of support of a CGT by Tax practitioners (n=147)

	*Level of support			Missing
	Mean	**Median**	**Mode**	
Status quo tax system	4.1	5	5	21 (14%)
Realisation-based CGT	2.8	3	1	26 (18%)
Accrual-based CGT	1.47	1	1	39 (27%)

*Ranging from 1 = strongly disagree to 5 = strongly agree

To mitigate the problem of high non response rates, a new factor "CGT priority" was constructed to examine the respondents' preference by ranking their maximum level of support for a CGT model and for the status quo tax system. The value of this factor ranges from "-1" to "1", where "-1" indicates opposition to a CGT, "0" indicates neutral (or equal maximum level of support for the status quo tax system and the CGT model) and a "1" indicates support for a CGT. For example, a person who gave attitude scores of 5 for status quo, 3 for realisation-based CGT and 1 for accrual-based CGT, would be given a "-1" score of CGT priority. The new factor also represents a comparison of the level of support between the status quo tax system and a realisation-based CGT as the attitude score for an accrual-based CGT was very low (strong disagreement). The statistics for the "CGT priority" factor are shown in Tables 4.4(b).

Table 4.4(b) Number of tax practitioners with CGT adoption decision (n=147)

	Frequency	Percent	Cumulative Percent
Status quo (or oppose CGT)	94	63.9	63.9
Neutral (or no priority)	6	4.1	68.0
Support for a CGT	47	32.0	100.0
Total	147	100.0	

Table 4.4 (b) above shows that 63.9% (n=94) of the tax practitioners preferred the status quo tax system, 32% (n=47) opted for a CGT model and 4% (n=6) indicated neutral/equal preference for the two tax systems. The result reinforced the finding that the practitioners generally preferred the status quo tax system.

Similar results were evident in the tax teacher survey responses. There were 13 tax teachers who expressed their support for or opposition to the introduction of a CGT. Only 4 (or 30.8%) supported the introduction of a comprehensive CGT system, 8 (61.5%) opposed it, and one (7.7%) was neutral about the adoption decision. Also it was noted that one of the eight CGT opponents was initially a CGT supporter, but later changed his mind after the interview.

Table 4.5 Number of respondents with CGT adoption decision (n=160)

	CGT proponents	CGT opponents	Neutral tax experts	Total
No. of respondents	51	102	7	160
Group				
Practitioners	47 (92.2%)	94 (92.2%)	6 (85.7%)	147 (91.9%)
Teachers*	4 (7.8%)	8 (7.8%)	1 (14.3%)	13 (8.1%)
Gender				
Male	39 (76.5%)	78 (76.5%)	7 (100%)	124 (77.5%)
Female	12 (23.5%)	24 (23.5%)	0 (0%)	36 (22.5%)
Region				
Auckland	19 (37.3%)	29 (28.4%)	3 (42.8%)	51 (31.9%)
North Island (except Auckland)	20 (39.2%)	50 (49.1%)	2 (28.6%)	72 (45%)
South Island	12 (23.5%)	23 (22.5%)	2 (28.6%)	37 (23.1%)

*This includes only the tax teachers who indicated their preference in the interviews

Table 4.5 above summarises the findings from the 160 tax experts (i.e., all 147 tax practitioners and the 13 tax teachers) who indicated their preference for a particular type of tax structure in the questionnaire or in the interviews. The majority (102 tax experts or 64%) supported the status quo (i.e., CGT opponents), while only 51 (or 32%) supported a comprehensive CGT system (i.e., CGT proponents). Seven (or 4%) were neutral about the adoption decision. Chi-Square tests were conducted to test if there were any differences in the demographic variables such as group, gender and geographical location amongst CGT proponents, opponents and neutral tax experts. The result revealed that there were no significant differences in the responses.

The unpopularity of CGT was also supported by the tax experts' written feedback in the questionnaire. Most expressed a preference for the status quo tax system and opposed the introduction of a comprehensive CGT. The reasons for their opposition were varied, but the most common criticism was that CGT was complex and created compliance issues. Further discussion on the qualitative feedback will be given in Chapter 5.

There was some mistrust and suspicion about the intention of the study by those who opposed a CGT. The cover letter had already mentioned that the purpose of the survey was to explore the tax experts' attitudes about a CGT, and was not intended to introduce the tax. Yet some respondents suspected that was the actual intention behind the survey and expressed their concern about the source of the study funding[45]. Also their opposition was often expressed by the use of negative words and phrases and negative criticisms. For example, they often stated "Don't like this", "Please, please, please don't bring CGT!!", "I am totally against CGT!!!!" In some extreme cases, they considered leaving the country if a CGT were introduced. As a respondent stated:

> I don't agree with capital gains tax at all! Basically I'd disagree with anything to do with CGT. I'd certainly consider leaving the country. One works all their lives to gain assets and I wouldn't vote

[45] This PhD study is a self-funded research project.

for anyone introducing this. That’s why all the politicians have TRUST.

4.2.2 Attitudes to general CGT issues

In part one of the questionnaire, respondents were asked to respond to the six CGT statements using a five-level Likert scale (ranging from strongly disagree, with a value of 1, to strongly agree, with a value of 5). With the form of ordinal data provided by a Likert scale, a comparison of medians is most technically appropriate, and non-parametric statistical tests need to be used. A summary of descriptive statistics is provided in Table 4.6.

Table 4.6 Attitude score on general CGT issues (n=175)

Questions	Mean	Median	Mode
1. As most of our trading countries have a CGT, implementation of a CGT is inevitable	2.6	2	1
2. Taxing capital gains will clarify (and possibly remove) the distinction between capital gains and income, therefore it reduces the uncertainty in the application of the tax law	2.88	3	4
3. The absence of any CGT in New Zealand provides significant opportunities for tax planning	3.95	4	4
4. CGT will raise revenue for the government if only by protecting the income tax base	3.25	3	4
5. CGT is double taxing investors as the money they invest in a business has already been taxed	2.99	3	2
6. Capital gains and income should be taxed on the same basis	2.29	2	1

*Ranging from 1 = strongly disagree to 5 = strongly agree

With a median score of 2 and a mode score of 1, the respondents generally disagreed or strongly disagreed that New Zealand would eventually follow the CGT approach of most trading countries (question 1), and also disagreed with equal tax treatment of capital gain and income on the same basis (question 6).

In contrast, they were uncertain about the positive and the negative effects of a CGT. With a mean of 2.88, median of 3 and mode of 4, the respondents were neutral about the statement "taxing capital gains will clarify (and possibly remove) the distinction between capital gains and income, therefore it reduces the uncertainty in the application of the tax law". A similar result was evident for question 4 where the tax experts were asked whether a CGT would "raise revenue by protecting the income tax base". Their responses were neutral with a mean of 3.25, a median of 3 and a mode of 4. When the respondents were asked about the problem of "double taxation effects on investors" in question 5, they also gave neutral responses (mean 2.99, median 3 and mode 2).

However, the responses for question 3 revealed that the tax experts agreed that the lack of CGT in New Zealand provided significant opportunities for tax planning (mean 3.95, median 4 and mode 4).

To compare the results between the tax teachers and the tax practitioners, Chi-Square tests were conducted to examine whether their responses were independent. Making inferences might not be possible for the cross-tabulations as the initial chi-square tests revealed that more than 20% of the cells did not meet the minimum expected value of 5. In order to meet the minimum statistical requirements, the five-level Likert scale was recoded into a three-level scale (i.e., disagree, neutral and agree). Only the responses for question 3, which sought the respondents' opinions about the opportunity for tax planning, were recoded into a Yes/No category as most responses were skewed to "agreement". By performing these transformations, the expected cell count did not exceed the 20% empty cell limit.

Table 4.7 Chi-Square scores for perception of general CGT issues by Group (n=175)

Variables	Chi-Square	Cramer's V
1. Trading partners	3.83	
2. Clarification of capital/income distinction	0.455	
3. Tax planning opportunities	0.521	
4. Income tax base protection	1.581	
5. Double taxation	8.122*	0.198
6. Equal tax treatment	6.967*	0.198

Note: *$p < 0.05$

Table 4.7 reveals no statistically significant relationship among the first four general CGT issues (trading partners, clarification of capital/income distinction, tax planning opportunities and income tax base protection). However, different responses were received from the tax teachers and the tax practitioners for double taxation ($p = 0.014$) and the equal treatment of income and capital gain ($p = 0.031$). Regarding double taxation, the tax teachers tended to disagree (with a lower mean 2.54 and mode 1) with the statement, while the tax practitioners were more neutral (mean of 3.09 and mode of 2). On the other hand, the tax teachers tended to be more neutral or agree to the statement "capital gains and income should be taxed on the same basis", while the tax practitioners tended to disagree with the statement (with a mean score of 2.19, median of 2 and a mode of 1). Cramer's V statistic is about 0.2 for each of the two variables (double taxation and equal tax treatment), and this represents a weak association between the CGT general issue and whether the tax expert is a tax teacher or a tax practitioner.

4.2.3 Comparison

Table 4.8 Median and mean scores on perception of CGT general issues by CGT proponents, opponents and neutral tax experts (n=160)

Variables	Proponents		Opponents		Neutral	
	Median	Mean	Median	Mean	Median	Mean
Trading partners	3.0	3.0	2.0	2.5	2.0	2.6
Clarification of capital/income distinction	4.0	3.2	2.0	2.7	2.0	2.6
Tax planning opportunities	4.0	3.9	4.0	3.9	5.0	4.6
Income tax base protection	4.0	3.5	3.0	3.1	3.0	3.1
Double taxation	2.0	2.5	4.0	3.3	2.0	2.3
Equal tax treatment	3.0	2.7	2.0	2.0	1.0	1.9

*ranging from 1 = strongly disagree to 5 = strongly agree

Table 4.8 compares the mean and median scores of the CGT proponents, opponents and neutral tax experts on the six CGT general issues. In general, the CGT proponents had a higher level of agreement for each of the statements than did the other groups of tax experts, with the exception of the double taxation argument which was a negative statement about a CGT.

For the first CGT general issue of trading partners, while the CGT proponents had mixed feelings about whether New Zealand would eventually follow the approach of most OECD countries (median and mean of 3), the CGT opponents and neutral tax experts generally disagreed that New Zealand would eventually follow this approach (median of 2).

The CGT proponents agreed that "taxing capital gains will clarify (and possibly remove) the distinction between capital gains and income; therefore, it reduces the uncertainty in the application of the tax law" (median of 4), while the other groups disagreed with the statement (median of 2).

It is interesting to note that all tax experts agreed that the absence of any CGT in New Zealand provides significant opportunities for tax planning with a mean score of about 3.9, median of 4 for both CGT proponents and opponents, and a higher median score of 5 for the neutral tax experts. These results showed that there was a general awareness of tax planning opportunities by all tax experts in New Zealand.

Different responses were received from the CGT proponents and the others for the statement about the income tax base protection. The CGT proponents had a higher median of 4, which was above the median 3 of the other groups. This result shows that the CGT proponents were more positive about the income tax protection provided by a CGT.

As regards the effect of double taxation of a CGT, both CGT proponents and neutral tax experts disagreed about this issue (median of 2). Only the CGT opponents agreed with it (median of 4).

Lastly, the CGT proponents were neutral in considering the statement "capital gains and income should be taxed on the same basis", while the other groups disagreed or strongly disagreed with the statement with a median of 2 for CGT opponents and 1 for the neutral tax experts.

Chi-Square tests were conducted to examine whether the responses of CGT proponents and opponents were independent. However, the initial chi-square tests revealed that results from the neutral tax experts (n = 7) did not meet the minimum expected value of 5. In order to meet the minimum statistical requirements, only responses from the CGT proponents and opponents were included for the purposes of the Chi-Square tests.

Table 4.9 Chi-Square scores on perception of general CGT issues by CGT proponents and opponents (n=153)

Variables	Chi-Square	Cramer's V
1. Trading partners	7.433	
2. Clarification of capital/income distinction	8.655 [a]	0.190
3. Tax planning opportunities	2.947	
4. Income tax base protection	6.896	
5. Double taxation	12.119*	0.282
6. Equal tax treatment	13.262*	0.296

Note: [a] $p < 0.1$, *$p < 0.05$

Table 4.9 reveals no statistically significant relationship for the variables – trading partners, tax planning opportunities and income tax base protection. Statistical significant differences were evident for CGT proponents and opponents in the responses to double taxation (p = 0.016) and the equal treatment of income and capital gain (p = 0.021). It is noted that the variable (the clarification of capital/income distinction) was statistically significant at p = 0.07. However, its Cramer's V statistic is 0.190 and represents a weak association. On the other hand, the variables – (double taxation and equal tax treatment) – had Cramer's V statistics of 0.282 and 0.296 respectively. This result indicated a medium relationship existed between the individual CGT general issues and the CGT adoption decision (i.e., CGT support or opposition).

4.2.4 Summary

In summary, the results from the survey showed that there was a general awareness of the tax planning opportunity because of a lack of a comprehensive CGT. However, most of the respondents were uncertain whether a comprehensive CGT was the best solution. They had mixed opinions about the issues of double taxation and the economic benefits derived from a CGT, such as protection of income tax base and clarification of the capital/income distinction. In particular, the tax teachers tended to disagree with the double taxation effect of a CGT, and agree on the equal tax treatment of income and capital gain, while the tax practitioners were more neutral about the double taxation and tended to disagree with the equal tax treatment.

For the comparison between the CGT proponents and opponents, it is found that all tax experts agreed with the statement that “the absence of any CGT in New Zealand provides significant opportunities for tax planning”. However, significantly different opinions were found in 1) the clarification of the capital/income distinction, 2) double taxation effect and 3) the equal treatment of income and capital income. The CGT proponents did perceive the CGT more positively than the CGT opponents did as the CGT proponents tended to agree with the benefit (the clarification of the income/capital distinction) and disagree with the negative effect of the tax (double taxation effect). Also, the CGT opponents disagreed with the equal treatment of income and capital income while the CGT proponents were neutral about the issue.

4.3 CGT asset coverage

Question 1-1 of part 2-1 of the questionnaire sought the tax experts’ comments on whether the 15 types of asset (such as private home, personal-use property) should be included in the CGT regime. The question was asked in a dichotomous Yes/No format. Occasionally, the respondents provided additional feedback by writing their comments beside a particular type of asset. The discussion of this qualitative information will also be included in Section 4.3.3.

4.3.1 Attitudes to the inclusion of CGT assets

The table 4.10 below summarises the relevant statistics. The significant items are also highlighted in bold.

Table 4.10 CGT asset coverage (n=175)

CGT asset	Frequencies (%) Yes	No
• Any chose in action (whether legal or equitable)	38.1*	61.9*
• Business goodwill	39.9	60.1
• **Collectables e.g., jewellery, stamps**	31.8	**68.2**
• Copyrights and patents	50	50
• Debt owed to a taxpayer	32	68
• Farms	52.1	47.9
• Land improvements	56.7	43.3
• Listed bonds and capital notes	55	45
• **Personal-use property e.g., home appliance, private car**	6.4	**93.6**
• **Private home (main residence)**	8.7	**91.3**
• **Rental home**	**61.3**	38.7
• **Second home e.g., beach house**	43.6	56.4
• Shares in a listed company	53.2	46.8
• Shares in a small company (non-listed)	40.6	59.4
• Share rights and options	50	50

*This category had high non response rate of 11.4% (n = 20)

Most of the respondents answered "no" to half of the CGT assets. In particular, above 90% of the respondents opposed the inclusion of personal-use property (93.6%) and main residence (91.3%). The majority of them wanted exemptions on CGT assets such as chose in action (whether legal or equitable), goodwill, collectables and debt asset owed to a taxpayer. Slightly more than half wanted exemptions on a second home and shares in a small, non-listed company.

On the other hand, the majority of the respondents agreed to taxing capital gains on the disposal of a rental home (61.3%). A slight majority agreed with the inclusion of farms, land improvements and listed bonds (representing 52.1%, 56.7% and 55% respectively). There was no majority on the inclusion of copyrights, shares in a listed company, and share options.

The taxation of capital gains on disposal of property represents the centre of attention for the tax experts. An overwhelming majority of the respondents opposed the taxation on a main residence (91.3%), but agreed on the taxation of capital gains on rental properties (61.3%), which was the highest percentage consensus of all for the inclusion of such an asset in the CGT regime. It is interesting to note that only a slight majority wanted exemptions on a second home (56.4%). The other significant issue was that the respondents had different views on the subject of taxation on debt equity and shares equity, that is, 68% of the respondents opposed taxation of a debt owed to a taxpayer compared to only 46.8% who opposed taxation on shares in a listed company.

It is also noted that some respondents did not know about the type of asset of "chose in action"[46]. The word "chose" is the French word for "thing". The word "chose" is pronounced like the English word "shows". The term may have been

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[46] According to the Butterworths New Zealand Law Dictionary, "Chose in action" is defined as "a thing of which a person has not the present enjoyment, but merely a right to recover it (if withheld) by action" (Spiller, 1995, p. 49). Examples of chose in action include money at a bank and money due on a bond. Choses in action, whether recoverable at law or in equity, can be regarded as CGT assets for taxation purposes in Australia under section 108-5 (b) of the Income Tax Assessment Act 1997.

unfamiliar to some of the respondents. This may explain the high non-response rate (11.4%) for this category.

Chi-Square tests were conducted to examine any significant differences in the responses given by the tax teachers and the tax practitioners. The categories where the tax teachers and the tax practitioners had different opinions were chose in action, collectables, private home, and second home. With the exception of private home, the majority of tax teachers favoured the inclusion of these assets while most tax practitioners wanted them to be exempt for CGT purposes. Although both tax teachers and tax practitioners opposed the taxation of capital gains on a private home, the percentages for those opposing the tax varied. An overwhelming majority of 93.8% of tax practitioners supported the exclusion while only 77.8% of the tax teachers favoured the exemption. Cramer's V statistic is about 0.2 for each of these four categories of CGT asset, and this figure represents a small association between the CGT asset and whether the tax expert is a tax teacher or a tax practitioner. The result of the Chi-Square test is shown in Table 4.11 below.

Table 4.11 Chi-Square for perception of asset coverage by Group (n=175)

CGT asset	Chi-Square	Cramer's V
• Any chose in action	5.105*	0.181
• Business goodwill	0.597	
• Collectables	7.308*	0.206
• Copyrights and patents	0.683	
• Debt owed to a taxpayer	0.599	
• Farms	2.743	
• Land improvements	0.508	
• Bonds and capital notes	0.238	

CGT asset	Chi-Square	Cramer's V
• Personal-use property	3.526	
• Private home	6.867*	0.199
• Rental home	0.128	
• Second home	3.981*	0.152
• Shares in a listed company	1.655	
• Shares in a small company	2.237	
• Share rights and options	0.171	

Note: $*p < 0.05$

4.3.2 Exemption threshold

Question 1-1 of part 2-1 also asked the respondents to specify an exemption threshold amount for each CGT asset that they thought should be included in the CGT regime. Since the majority of the respondents wished to exclude the capital gains from most of the CGT assets, those respondents were not required to answer this question. As for those who were required to specify an amount, many of them simply selected "yes" and otherwise left the answer blank. As a result, this question overall had a relatively low number of responses, and the value distribution of the exemption amount was skewed. The exemption amount was recoded into a five-scale format in order to reduce the problem of distortion. It is noted that the threshold of the scale for one CGT asset might be different to that for the others because of the large exemption amount required for assets such as farms and property. This section will report only the mode score i.e., the most frequently occurring score on one of the five-scale categories. A summary of the mode scores of the exempted amount is given in Table 4.12.

Table 4.12 Respondents and the amount of exemption of CGT asset (n=175)

CGT asset	Number of respondents (frequency %)	Mode: The most frequently occurring CGT exemption threshold
• Any chose in action	10 (66.7%)	$1 – 50,000
• Business goodwill	12 (80%)	$1 – 50,000
• Collectables	11 (35.5%)	$5,001 - 10,000
• Copyrights and patents	8 (42.1%)	$50,001 – 100,000
• Debt owed to a taxpayer	2 (22.2%) 2 (22.2%) 2 (22.2%)	$1,001 - 5,000* $5,001 - 10,000* $10,001 - 50,000*
• Farms	17 (56.7%)	$1 - 500,000
• Land improvements	12 (42.9%)	$1 – 50,000
• Bonds and capital notes	7 (31.8%)	$1,001 - 5,000
• Personal-use property	4 (66.7%)	$10,001 – 50,000
• Private home	3 (37.5%)	$250,001 – 500,000
• Rental home	14 (63.6%)	$1 – 100,000
• Second home	11 (45.8%)	$1 – 100,000
• Shares in a listed company	7 (33.3%)	$1,001 – 5,000
• Shares in a small company	5 (26.3%) 5 (26.3%)	$5,001 – 10,000* $10,001 – 50,000*
• Share rights and options	4 (26.7%)	$5,001 – 10,000

*Multiple modes exist.

The respondents gave diverse answers as shown in Table 4.12. The mode statistics were used to analyse the level of the exemption threshold. In some cases, multiple modes were evident and were used in the result. It is noted that the results for some asset categories were heavily biased due to the low response rate. As such, the focus falls on those significant asset categories.

Generally, the respondents indicated an exemption threshold amount: $5,001 – 10,000 for collectables; $1 – 500,000 for farms; $1 – 50,000 for land improvements, and $1,001 – 5,000 for shares in a listed company. Multiple modes existed for the exemption threshold for shares in a private company ($5,001 – 10,000 and $10,001 - $50,000).

A comparison of the size of the exemption between private home and other property such as a second home and rental home revealed that the respondents provided different exemption amounts depending on the nature of the property. Closer analysis of the 24 responses which specified an exemption amount also showed that they were more likely to provide a higher level of exemption for a second home than for a rental home. A similar result was evident in the preceding question.

4.3.3 Supplementary information

In question 1-1 of part 2-1 of the questionnaire, a number of tax practitioners expressed their concerns about the taxation of capital gains on certain types of assets. This feedback was given in the form of side notes and foot notes. For example, some respondents suggested alternatives for providing exemption for the capital gain. One respondent suggested that rather than using monetary value, the exemption amount could be expressed as a percentage based calculation, and vary for each type of asset e.g., 20% discount for business goodwill. Another respondent considered that goodwill, bond, rental home, second home, listed company shares and non-listed shares should be given in the form of a rebate instead of an exemption, and suggested that the exemption rebate for farms should be based on the age/length of time the farm was in business.

The respondents were initially expected to answer the question 1-1 as if a CGT had been introduced in New Zealand. Some of the tax practitioners, however, stated that "the tax should not be introduced". Closer analysis of their responses revealed that they were confused about the comprehensive CGT with the status quo tax system, which was often referred to by them as a "New Zealand-style CGT" or "New Zealand hybrid income tax system". For example, they supported a CGT on disposal of land improvements, a rental home, a second home and listed company shares. But they considered that the gains should be limited to the developers/traders only. Or in another case, they considered the CGT on a rental home should be limited to "excess of depreciation over claw-back", and the gain on disposal of collectables should be taxable if the assets were purchased with the intention of selling at a profit. Similar results were evident in the interview phase. The respondents' preferences for the status quo are discussed in the later qualitative data analysis in chapter 5.

4.3.4 International taxation

Questions 9 and 10 of part 3 of the questionnaire sought the respondents' opinions about the application of the residence rule and the source rule in relation to international taxation. Table 4.13 shows that the respondents agreed with the statement that "New Zealand tax residents' overseas assets" should be included for CGT purposes (mean 3.58, median 4 and mode 5). They also strongly agreed that "non-residents should pay CGT if they earn capital gains from disposing of New Zealand assets" (mean 4.11, median 5 and mode 5).

Table 4.13 International taxation (n=175)

	Mean *	Median *	Mode *
Do you think New Zealand tax residents' overseas assets should be included for CGT purposes?	3.58	4	5
Do you think non residents should pay CGT if they earn capital gains from disposing of New Zealand assets?	4.11	5	5

*ranging from 1 = strongly disagree to 5 = strongly agree

Chi-square tests were conducted to test whether the responses of the tax practitioners and the tax teachers were independent, but in all cases there were no significant differences in the groups' responses.

4.3.5 Comparison

Table 4.14 CGT asset coverage (in frequency percentage) by CGT proponents, opponents and neutral tax experts (n=160)

CGT asset	**Proponents**		**Opponents**		**Neutral**	
	Yes (%)	No (%)	Yes (%)	No (%)	Yes (%)	No (%)
Any chose in action	57.1	42.9	28	72	66.7	33.3
Business goodwill	56.9	43.1	31	69	57.1	42.9
Collectables	39.2	60.8	27	73	42.9	57.1
Copyrights and patents	64	36	43	57	71.4	28.6
Debt asset owed to a taxpayer	**40**	**60**	**28.6**	**71.4**	**14.3**	**85.7**
Farms	74	26	38.8	61.2	71.4	28.6
Land improvements	76	24	47	53	71.4	28.6
Bonds and capital notes	77.6	22.4	45	55	71.4	28.6
Personal-use property	**2**	**98**	**6**	**94**	**28.6**	**71.4**
Private home	**9.8**	**90.2**	**7**	**93**	**14.3**	**85.7**
Rental home	**82.4**	**17.6**	**51**	**49**	**85.7**	**14.3**
Second home	58	42	36	64	57.1	42.9
Shares in a listed company	76.5	23.5	41	59	71.4	28.6
Shares in a small company	62.7	37.3	28.3	71.7	71.4	28.6
Share rights and options	74.5	25.5	39.4	60.6	71.4	28.6

Table 4.14 compares the frequency percentages for the CGT proponents, opponents and neutral tax experts on CGT asset coverage. It is not surprising to find that the CGT proponents generally agreed with the inclusion of most of the CGT assets, with the exceptions of debt asset (40%), personal-use property (2%) and private home (9.5%). Also it is interesting to note that the neutral tax experts shared a similar attitude. In contrast, the CGT opponents disagreed with the inclusion of most of the CGT assets. The only exceptions were the inclusion of land improvements, bonds, and rental homes about which the CGT opponents had neutral opinions. Nonetheless, all groups of tax experts opposed the inclusion of collectables, debt owed to a taxpayer, personal-use property and private homes. This result coincided with the findings on section 4.3.1 above.

It is interesting to note that the taxation of capital gains on disposal of property was overwhelming opposed when it was to taxation on a main residence. However, a strong majority of CGT proponents (82.4%) and the neutral tax experts (85.7%) supported the inclusion of rental property, while the CGT opponents had mixed opinions (51%). Also it is noted that only a slight majority of the CGT proponents (58%) and neutral tax experts (57.1%) wanted taxation of capital gains on disposal of a second home. This result again coincided with the overall results in section 4.3.1. Another similar trend was evident in the different treatments regarding the inclusion of debt equity and shares equity on the part of the CGT proponents and the neutral tax experts. These two groups generally opposed the inclusion of debt owed to a taxpayer but supported the inclusion of shares in a listed company.

Table 4.15 Implementation of the residence rule and the source rule by CGT proponents, opponents and neutral tax experts (n=160)

International taxation	**Proponents**		**Opponents**		**Neutral**	
	Median	Mean	Median	Mean	Median	Mean
Residence	4	3.72	4	3.44	4.5	4
Source	5	4.19	5	4.07	4.5	4

*ranging from 1 = strongly disagree to 5 = strongly agree

Table 4.15 compares the median and mean for the CGT proponents, opponents and neutral tax experts on the application of the residence rule and the source rule in relation to international taxation. It shows that all the tax experts agreed with the implementation of the residence rule (median 4), and strongly agreed with the application of the source rule for non resident taxpayers (median of 5).

Chi-Square tests were used to test whether the responses of CGT proponents and opponents were independent. As with previous Chi-Square tests, responses from the neutral tax experts were excluded in order to meet the minimum expected value requirements.

Table 4.16 Chi-Square scores for CGT asset coverage from CGT proponents and opponents

CGT asset	Chi-Square	Cramer's V
• Any chose in action	10.569**	0.28
• Business goodwill	9.434**	0.25
• Collectables	2.351	
• Copyrights and patents	5.88*	0.198
• Debt owed to a taxpayer	1.973	
• **Farms**	**16.435****	**0.333**
• Land improvements	11.416**	0.276
• **Bonds and capital notes**	**14.122****	**0.308**
• Personal-use property	1.246	
• Private home	0.363	
• **Rental home**	**14.034****	**0.305**
• Second home	6.57*	2.09
• **Shares in a listed company**	**17.058****	**0.336**

CGT asset	Chi-Square	Cramer's V
• **Shares in a small company**	**16.657****	**0.333**
• **Share rights and options**	**16.615****	**0.333**
International taxation		
• Residence rule	1.498	
• Source rule	3.648	

Note: *p < 0.05, **p <0.01

Table 4.16 shows a statistically significant relationship for most of the CGT assets, except collectables, debt asset, personal-use property and the private home. In particular, large levels of significance and medium strength of association were evident for farms, bonds, a rental home, shares in a listed company, shares in a small company and share rights, where p value < 0.01 and Cramer's V statistics were about 0.3 (i.e., medium association). This result seems to represent the fact that the CGT proponents' opinions were likely to be different from those of CGT opponents regarding the CGT asset coverage. Also the non significant differences in responses to collectables, debt asset, personal-use property and private home between CGT proponents and opponents supported the notion that these assets should be excluded from the tax base for CGT purposes.

For international taxation, there were no significant differences between the CGT proponents and opponents in regard to the application of the residence rule and the source rule.

4.3.5 Summary

In summary, the tax experts voted "no" to half of the CGT assets. In particular, an overwhelming majority opposed the inclusion of personal-use property and the main residence. However, the majority of the same respondents agreed to tax capital gains on the disposal of a rental home. It is interesting to note the differences in their perceptions of the tax treatment of main residence, rental properties and second home. These results revealed the significance of the taxation of capital gains on disposal of residential property in the tax experts' decision making process. Also it is noted that they perceived the taxation of debt equity and shares equity differently.

Another significant item is the capital gain on collectables. A strong majority favoured exempting capital gains on collectables. They indicated an exemption threshold of $5,001 to 10,000. It is noted that the majority of the tax teachers tended to favour their inclusion with some exemption while most tax practitioners wanted collectables to be fully exempted for CGT purposes.

While it is not surprising to find that CGT proponents and CGT opponents had very different opinions regarding CGT asset coverage, it is, however, found that there were no statistically significant differences in their responses to 1) collectables, 2) debt asset, 3) personal-use property and 4) a private home. This result suggests that both groups of tax experts agreed that these four types of assets should be excluded from the tax base for CGT purposes. Also they agreed to the implementation of the residence rule and the source rule in relation to international taxation.

4.4 Cost base

Table 4.17 below revealed the tax experts' responses to whether nine common cost items (such as purchase price and legal fees) should be included in the computation of the cost base of CGT. The answer choice was structured in a five-level Likert scale (ranging from strongly disagree, with a value of 1, to strongly agree, with a value of 5). In general, the respondents agreed or strongly agreed (median of 4 and 5 respectively) to include all items, except contingent liabilities, and repair and maintenance expenses (neutral opinions with median of 3) in the calculation of the cost base of CGT. Also it is noted that debts to finance the property and interest had a lower level of agreement (median of 4 and 5 respectively but mean statistics (lower than 4) among other items that had stronger levels of agreement (mean statistics of 4 and above).

Table 4.17 Items for calculation of the cost base (n=175)

Item	Mean*	Median*	Mode*
Agent fees e.g. commission and brokerage	4.35	5	5
Contingent liabilities	3.22	3	5
Debts to finance the property	3.63	4	5
Improvement expenditure for property	4.39	5	5
Interest for financing the property	3.59	5	5
Legal fees and stamp duty	4.4	5	5
Market value of any property a taxpayer gave or is required to give in respect of acquiring a CGT asset	4.18	5	5
Purchase price	4.49	5	5
Repair and maintenance expenses	3.18	3	5

*ranging from 1 = strongly disagree to 5 = strongly agree

General observation of the statistical data reveals, not surprisingly, that the tax practitioners tended to support the inclusion of all cost items for the calculation of the deductible cost base of CGT (median of 5 in most cases). In contrast, although the tax teachers also agreed to include most of the items for the computation of the cost base (median of 4 or above), they were neutral towards some of the cost items, for example, the contingent liabilities, debts to finance the property, and the repair and maintenance expenses (median of 3). To compare the results for the two groups of tax experts, Chi-Square tests were conducted to examine whether their responses were independent. In order to meet the minimum statistical requirements, the five-level Likert scale was recoded into a three-level scale (i.e., disagree, neutral and agree) for contingent liabilities, debts to finance the property, interest payment, and repair and maintenance expenses. The responses for the cost item (market value of property given) were further recoded into a Yes/No category as most responses were skewed to "agreement". No further re-coding was possible for four cost items: agent fee, property improvement expenditure, legal fees, and purchase price as the responses were heavily skewed to "agreement" and more than 20% of the cells had an expected count less than 5. No Chi-Square test thus could be conducted for these four cost items. By performing these transformations, the expected cell count of the other cost items did not exceed the 20% empty cell limit.

Table 4.18 Chi-Square for CGT cost base by group (n=175)

Item	**Chi-Square**	**Cramer's V**
Agent fees e.g. commission and brokerage	N.A.	
Contingent liabilities	9.903**	0.243
Debts to finance the property	6.715**	0.2
Improvement expenditure for property	N.A.	
Interest for financing the property	3.538	
Legal fees and stamp duty	N.A.	
Market value of any property a taxpayer gave or is required to give in respect of acquiring a CGT asset	0.228	
Purchase price	N.A.	
Repair and maintenance expenses	3.543	

Note: N.A. = no Chi-Square test was conducted.
**$p < 0.01$

Table 4.18 revealed no statistically significant relationship for most cost items. However, different responses from the tax teachers and the tax practitioners were evident for 1) contingent liabilities and 2) debts to finance the property. For these two cost items, the tax practitioners tended to support their inclusion (median 3 and 4 respectively, and a high mode of 5 for both cases), while the tax teachers were more neutral (median and mode of 3 for both items). Cramer's V statistic is 0.243 for contingent liabilities and 0.2 for debts. This result suggests a small to medium association between the inclusion of contingent liabilities and the fact that the tax expert is either a tax teacher or a tax practitioner. Any relationship between the debts variable and the different groups of tax experts is rather weak.

4.4.1 Comparison

Table 4.19 Items for computation of cost base by CGT proponents, opponents and neutral tax experts (n=160)

Cost item	Proponents		Opponents		Neutral	
	Median	Mean	Median	Mean	Median	Mean
Agent fees	5	4.46	5	4.36	5	4.17
Contingent liabilities	3	3.22	4	3.39	4	3.33
Debts	5	3.6	4	3.76	4	3.5
Improvement expenditure	5	4.46	5	4.43	4.5	4
Interest	5	3.64	5	3.71	4	3.5
Legal fees and stamp duty	5	4.49	5	4.47	4.5	4
Property given in acquiring a CGT asset	5	4.23	5	4.23	4.5	3.83
Purchase price	5	4.63	5	4.54	5	4.17
Repair and maintenance	3	3.24	4	3.28	2	2.67

*ranging from 1 = strongly disagree to 5 = strongly agree

Table 4.19 compares the mean and median scores for the CGT proponents, opponents and neutral tax experts on the nine cost items in the computation of the CGT cost base. The general observation was that all groups of tax experts shared similar attitudes towards the inclusion of the items, with the exception of the inclusion of 1) contingent liabilities and 2) repair and maintenance expenses. The CGT proponents tended to be neutral about these two cost items (median of 3), while the CGT opponents preferred to give a higher level of support (median of 4). In contrast, the neutral tax experts expressed different opinions by agreeing to the inclusion of contingent liabilities (median 4) but opposing the inclusion of the repair and maintenance expenses (median 2).

Chi-square tests were conducted to test whether the responses of CGT proponents and opponents were independent, but in all cases there were no significant differences in the responses between the groups.

4.5 CGT realisation events and rollover relief

Question 1-2 in part 2 of the questionnaire sought the tax experts' opinions (based on a five point Likert scale) on 14 situations ("CGT events") that would trigger a CGT. Under a realisation-based system, a CGT obligation arises when a taxpayer has "disposed" of a property and a capital gain is deemed to be "realised". It is noted that the term "realised" has a broader meaning, which includes situations where a taxpayer may realise a CGT liability even though there is no physical "disposal" of a property taking place. One example of this situation is the spousal transfer caused by a marriage break-down. Under the five-point Likert scale, a high median score of five indicated a strong level of agreement on a CGT event in which a taxpayer should be deemed for CGT purposes to have "disposed" of a property. On the other hand, a low median score of one indicated a strong level of disagreement on realisation which could be defined as a strong desire for the introduction of rollover relief on a situation. The results are summarised in Table 4.20.

Table 4.20 Situations where a "disposal" of a property taken place for CGT purposes (n=175)

CGT Events	Mean*	Median*	Mode*
Assets-for-shares acquisition	2.88	3	1
Business relocation	2.34	2	1

CGT Events	Mean*	Median*	Mode*
Gifting away the asset	2.99	3	4
Incorporation of a company	2.19	2	1
Insurance payment for destroyed property	2.81	3	1
Involuntary disposition e.g. compulsory acquisition by the government	2.55	2	1
Like-kind property exchange	2.92	3	1
Liquidations including the situation where a wholly owned subsidiary is wound-up into its parent	2.92	3	4
Reinvestment in replacement property	2.78	3	1
Renewal of a lease agreement	2.19	2	1
Share-for-share exchanges	2.76	3	1
Termination of a contract	2.87	3	3
Transfers of assets between related parties including spousal transfer	2.48	2	1
When a taxpayer ceases to be a tax resident in New Zealand	**3.35**	**4**	**5**

*ranging from 1 = strongly disagree to 5 = strongly agree

Table 4.20 notes that the respondents generally were uncertain or neutral about the situations that would trigger a CGT liability, as more than half of the realisation events had a median score of 3 (which represents "don't know" or "neutral"). The only CGT event that they agreed on was "when taxpayers ceased to be a tax resident" (median 4 and mode 5).

On the other hand, they would like to see rollover relief (non realisation) for business relocation, incorporation of a company, involuntary disposition, renewal of a lease agreement, and transfers of assets between related parties (all had a median of 2 and a mode of 1).

As more than half of the realisation events had a median score of 3, the finding reflected how respondents found it difficult to make decisions in an imaginary CGT environment. Rollover and realisation events are specific, technical tax issues which require specialised expertise within the discipline of CGT.

To compare the results from the tax practitioners and tax teachers, Chi-Square tests were conducted to examine whether their responses were independent. In order to meet the minimum statistical requirements, the five-level Likert scale was recoded into a three-level scale (i.e., disagree, neutral and agree) for the CGT events- business relocation, gifting, company incorporation, involuntary disposition, reinvestment in replacement property, renewal of a lease agreement, share-for-share exchanges, and transfers of assets between related parties. The expected cell count of all CGT events met the 20% empty cell requirement after the transformation.

Table 4.21 Chi-Square for CGT events by Group (n=175)

CGT Events	Chi-Square	Cramer's V
Assets-for-shares acquisition	1.841	
Business relocation	1.841	
Gifting away the asset	6.873*	0.2
Incorporation of a company	5.371	
Insurance payment for destroyed property	2.841	
Involuntary disposition	4.042	
Like-kind property exchange	1.083	
Liquidations	3.433	

CGT Events	Chi-Square	Cramer's V
Reinvestment in replacement property	1.216	
Renewal of a lease agreement	5.259	
Share-for-share exchanges	2.635	
Termination of a contract	2.313	
Transfers of assets between related parties	2.657	
When a taxpayer ceases to be a tax resident	0.84	

*p < 0.05

Table 4.21 reveals no statistically significant relationship in most of the CGT events. The two groups of tax experts had different responses to the CGT event only when an asset was gifted away. The tax teachers tended to support the inclusion (median 4 and mode 4), while the tax practitioners were more neutral (median of 3 and mode of 4). Cramer's V statistic is 0.2 and this suggests a small-to-medium association between the CGT event and the tax expert being a tax teacher or a tax practitioner.

4.5.1 Comparison

Table 4.22 Situations where a "disposal" of a property taken place for CGT purposes by CGT proponents, opponents and neutral tax experts (n=160)

CGT Events	**Proponents**		**Opponents**		**Neutral**	
	Median	Mean	Median	Mean	Median	Mean
1. Asset-for shares acquisition	4	3.53	2	2.53	4	3.14
2. Business relocation	3	2.75	1	2.01	4	3.57
3. Gifting away the asset	4	3.39	2	2.64	4	3.57
4. Incorporation of a company	2	2.59	1	1.98	1	2.29
5. Insurance payment for	4	3.32	2	2.45	4	3.71

CGT Events	Proponents		Opponents		Neutral	
destroyed property						
6. Involuntary disposition	3	3.14	2	2.19	3	2.71
7. Like-kind property exchange	4	3.53	2	2.54	4	3.57
8. Liquidations	4	3.31	3	2.64	3	3.29
9. Reinvestment in replacement property	4	3.41	2	2.33	4	3.71
10. Renewal of a lease agreement	3	2.45	1	1.9	3	3
11. Share-for-share exchanges	3	3.31	2	2.37	5	4.17
12. Termination of a contract	4	3.45	2	2.48	3	3.57
13. Transfers of assets between related parties	3	3.08	2	2.15	2	2.57
14. When a taxpayer ceases to be a tax resident	4	3.88	3	3.04	4	3.71

*ranging from 1 = strongly disagree to 5 = strongly agree

Table 4.22 compares the mean and median scores of the CGT proponents, opponents, and neutral tax experts on the 14 situations that will trigger a CGT liability. It is not surprising to find that the CGT opponents opposed, or were strongly opposed to, most situations (median 2 or below). The only exception is they had neutral opinion about the situation “when a taxpayer ceases to be a tax resident” (median 3).

In contrast, the CGT proponents agreed on the CGT events: asset-for-shares acquisition, gifting of an asset, insurance payment for destroyed property, like-kind property exchange, liquidations, reinvestment in replacement property, termination of a contract, and the termination of tax residence (median 4). The only CGT event where they preferred rollover was company incorporation (median 2). They were neutral about the other events. It is noted that the neutral tax experts also generally shared similar attitudes with the CGT proponents. But the neutral tax experts disagreed with a CGT liability on the transfers of assets between related parties, although the CGT proponents were neutral about the issue.

Chi-square tests were conducted to test whether the responses of CGT proponents and opponents were independent. The responses from the neutral tax experts were excluded in order to meet the statistical requirements i.e., minimum expected value of 5.

Table 4.23 Chi-Square for CGT events by CGT proponents and opponents (n=153)

CGT Events	Chi-Square	Cramer's V
Assets-for-shares acquisition	17.533**	0.343
Business relocation	9.832*	0.257
Gifting away the asset	15.763**	0.325
Incorporation of a company	10.742*	0.269
Insurance payment for destroyed property	16.24**	0.331
Involuntary disposition	17.893**	0.347
Like-kind property exchange	17.871**	0.346
Liquidations	8.141[a]	0.235
Reinvestment in replacement property	**23.125****	**0.397**
Renewal of a lease agreement	15.337**	0.323
Share-for-share exchanges	15.486**	0.323
Termination of a contract	**22.274****	**0.388**
Transfers of assets between related parties	**21.267***	**0.379**
When a taxpayer ceases to be a tax resident	12.559*	0.291

Note: [a] $p < 0.1$ *$p < 0.05$, **$p < 0.01$

Chi-Square tests revealed significant differences in most of the responses between the CGT proponents and opponents (as shown in Table 4.23). In most of the cases, the null hypothesis is rejected at the significance level of 1%. Also the Cramer's V of the majority of the CGT events is generally more than or equal to 3, which indicates a medium association between the CGT event and whether the tax expert is a CGT proponent or an opponent. In particular, the Cramer's V of each of the three CGT event variables – reinvestment in replacement property, termination of contract and transfers of assets between related parties – is about 4 (highlighted in Table 4.23). This figure suggests a medium to large relationship between the CGT event and the CGT adoption decision of the tax experts. No significant differences in responses towards the perceptions of the CGT event – liquidation – were seen. (It is, however, noted that the null hypothesis is rejected at a level of significance of 10%).

4.6 CGT preferences

Questions 1-3, 3-7 and 3-8 of the questionnaire explored various CGT preferences that would overcome the economic distortions when a CGT was introduced. The tax experts' attitude scores for these CGT preferences are summarised in Table 4.24 below.

Table 4.24 CGT preferences (n=175)

CGT preferences	Mean*	Median	Mode
1. Do you think the cost base should be adjusted for inflation e.g., indexation for capital gains?	**3.85**	**5**	**5**
2. Do you think a tapering discount should be provided in order to reduce the lock-in effect?	3.7	4	5
3. Do you think an averaging relief should be provided in order to reduce the bunching effect?	3.65	4	5

CGT preferences	Mean*	Median	Mode
4. Do you think a tax relief should be provided for disposal of a small business (e.g., turnover of less than $1 million)?	3.53	4	5
5. Do you think a tax relief should be provided for new/innovative business ventures?	3.33	4	5
6. Do you think a general exemption should be provided for small gains (e.g., the total of capital gains of a taxpayer which less than $1,000) because of administrative simplicity?	**4.57**	**5**	**5**
7. Do you think a partial exemption should be provided for the disposal of active assets of a small business (whose annual turnover is less than $1 million)?	**3.88**	**5**	**5**

*ranging from 1 = strongly disagree to 5 = strongly agree

Table 4.24 shows that the tax experts gave median scores of 4 or above to the seven statements which indicated that they generally agreed on the provision of all these CGT preferences. In particular, they strongly agreed that the cost base should be adjusted for inflation e.g., indexation for capital gains, the provision of general exemption for small gains for administrative simplicity, and partial exemption for disposal of active assets of small businesses (median 5 and mode 5).

Chi-Square tests were conducted to examine whether the responses of the tax practitioners and tax teachers were independent. In order to meet the minimum statistical requirements, the five-level Likert scale was recoded into a three-level scale (i.e., disagree, neutral and agree). By performing this transformation, the expected cell count of the other cost items did not exceed the 20% empty cell limit.

Table 4.25 Chi-Square for CGT preferences by Group (n=175)

CGT preferences	Chi-Square	Cramer's V
1. Indexation	0.238	
2. Tapering discount	1.66	
3. Averaging relief	0.741	
4. Small business exemption	3.475	
5. New/innovative business exemption	7.988*	0.216
6. General exemption for small gains	1.689	
7. Partial exemption for active assets of small businesses	1.368	

Note: * $p < 0.05$

Table 4.25 reveals no statistically significant relationship in most CGT preferences. Different responses were evident from the tax teachers and the tax practitioners for new/innovative business exemption. The tax practitioners tended to agree with the inclusion of such relief (median 4 and mode 5), while the tax teachers tended to oppose it (median 2.5 and mode 1). Cramer's V statistic is 0.216 which suggests a small to medium association between the exemption for new/innovative businesses and whether the tax expert is a tax teacher or a tax practitioner.

4.6.1 Comparison

Table 4.26 Median and mean scores for perception of CGT preferences by CGT proponents, opponents and neutral tax experts (n=160)

CGT preferences	Proponents		Opponents		Neutral	
	Median	Mean	Median	Mean	Median	Mean
1. Indexation	**5**	**4.1**	**5**	**3.84**	**2**	**2.43**
2. Tapering discount	4	3.59	4	3.83	4	3.71
3. Averaging relief	4	3.76	4	3.75	3	2.43

CGT preferences	Proponents		Opponents		Neutral	
4. Small business exemption	3	3.27	4	3.82	2	2.43
5. New/innovative business exemption	3	3.22	4	3.62	1	1.86
6. General exemption for small gains	**5**	**4.47**	**5**	**4.64**	**5**	**4.83**
7. Partial exemption for active assets of small businesses	4	3.57	5	4.13	4.5	4.17

*ranging from 1 = strongly disagree to 5 = strongly agree

Table 4.26 compares the mean and median scores of the CGT proponents, opponents and neutral tax experts on the seven CGT preferences. In general, the CGT opponents agreed with the provisions of all these CGT preferences (median of 4 or above). Also both CGT proponents and opponents shared similar positive attitudes regarding the provisions of most of the CGT preferences (median of 4 or above) with the exception of the small business exemption and a new/innovative business exemption where the CGT proponents had neutral opinions. It is noted that all tax experts strongly agreed with the adjustment for inflation (e.g., indexation) and the general exemption for small gains (median of 5). On the other hand, the neutral tax experts provided different opinions than the others. In particular, they tended to oppose the indexation, small business exemption and exemption for new/innovative businesses (median of 2 or below).

Chi-Square tests were conducted to examine whether the responses of the CGT proponents and opponents were independent. In order to meet the minimum statistical requirements, the five-level Likert scale was recoded into a Yes/No category for the CGT preference – indexation – as most responses were skewed to “agreement”. However, since the CGT preference – small general exemption – was heavily skewed to “agreement”, no further re-coding was possible and thus no Chi-Square test could be conducted. By performing these transformations, the expected cell count of the CGT preferences did not exceed the 20% empty cell limit.

Table 4.27 Chi-Square for CGT preferences by CGT proponents and opponents (n=153)

CGT preferences	Chi-Square	Cramer's V
1. Indexation	0.789	
2. Tapering discount	6.78	
3. Averaging relief	10.373*	0.263
4. Small business exemption	10.682*	0.268
5. New/innovative business exemption	4.894	
6. General exemption for small gains	N.A.	
7. Partial exemption for active assets of small businesses	10.667*	0.279

Note: N.A. = no Chi-Square test was conducted
*$p < 0.05$

Table 4.27 reveals significant differences in responses for the provisions of 1) averaging relief, 2) tax relief for small business with turnover less than $1 million and 3) partial exemption for disposal of active assets of a small business. Cramer's V statistic is about 0.26 which suggests a slight small to medium association between each of the exemptions and the tax experts' CGT adoption decision.

4.7 Integration with current tax legislation

This section discusses the research findings for the questions on part three of the questionnaire which relates to the practical issues required to integrate a CGT into the current tax system. These practical issues include: 1) setting the taxes rates and structure, 2) arranging capital loss and company CGT credit, and 3) repealing existing legislation.

4.7.1 Tax rates and structure

When asked about the general structure of CGT, 51.8% of the respondents preferred CGT to be part of income tax and the remaining 48.2% supported CGT as a separate tax. For the tax rates, 51.8% of the respondents preferred lower income tax rates, 45.8% supported the same tax rates as for ordinary income and only 2.4% supported higher CGT tax rates than those in ordinary income. These results revealed that there was a mix of opinions about the CGT structure and the tax rates in general.

Chi-Square tests were conducted to examine whether the responses of the tax practitioners and tax teachers were independent. In order to meet the minimum statistical requirements, the three-scale tax rates were recoded into a two-level scale (i.e. lower than income tax rates and equal to or above ordinary income tax rates). By performing this transformation, the expected cell count of the other cost items did not exceed the 20% empty cell limit.

Table 4.28 Chi-Square for tax structure and tax rates by Group (n=175)

	Chi-Square	**Cramer's V**
Structure	5.195*	0.178
Tax rates	5.216*	0.177

Note: * $p < 0.05$

Table 4.28 reveals that significantly different responses were evident for the tax teachers and for the tax practitioners. The majority of the tax teachers (70.4%) favoured the integration of CGT as part of the income tax system, while the tax practitioners had mixed opinions about it (47.8% supported integration with the income tax legislation and 52.2% supported a separate tax approach). Similar trends were found in their responses for the application of the tax rates. The majority of the tax teachers (70.4%) favoured the application of the ordinary income tax rates, 29.6% supported a lower income tax rates approach and none of the tax teacher chose the option “higher than income tax rates”. In contrast, the tax practitioners had mixed opinions about the tax rates (55.8% supported lower rates, 41.3% supported ordinary tax rates and 2.9% opted for higher income tax rates).

Cramer’s V statistic is about 0.178 which suggests the tax structure and tax rates were slightly statistically associated with the type of tax experts. The support of the majority of tax teachers for integration with income tax system and the application of ordinary tax rates revealed their preference for consistent treatment of the taxation of capital gains and ordinary income.

4.7.2 Capital loss and company tax credit

Table 4.29 Treatment of unused capital losses (n=175)

Type of taxpayer/ Treatment of unused capital losses	Individual (%)	Corporate (%)
Tax refund	38.5	28.6
Carry forward	61.5	71.4
Total	100	100

In Table 4.29, it is revealed that the majority of respondents agreed that any unused capital loss should be carried forward to the next financial year for individual and corporate taxpayers (61.5% and 71.4% respectively).

Table 4.30 Attitude scores on practical issues (n=175)

Practical issues	Mean	Median	Mode
1. Do you think capital loss should be regarded as a deductible expense which can be set against gross income?	3.82	4	5
2. Do you think CGT paid at the company level should be transferred to the shareholder as CGT credits?	3.72	4	5
3. Do you think a deemed “market value” should be applied on the disposal price when there is lack of or no consideration? (e.g. non-arm-length transaction and gifts)	4.08	5	5

*ranging from 1 = strongly disagree to 5 = strongly agree

Table 4.30 shows the mean, median and mode scores for the three practical CGT issues relating to the treatment of capital loss, the transfer of company CGT credit to individual shareholders, and the measure for anti-avoidance. There was a strong level of agreement (a median of 4 and mode of 5) to the deductibility of capital loss against gross income (ordinary income). The tax experts also agreed that "CGT paid at the company level should be transferred to the shareholder as CGT credits" (median 4 and mode 5). These results confirmed that they preferred a neutral tax system where CGT credit would be transferable to the individual and that capital loss could be offset against income. However, it is important to have some anti-avoidance measure to stop taxpayers from manipulating a CGT. On this aspect, the tax experts strongly agreed that a deemed "market value" regime should apply to the disposal price when there was a lack or no consideration given by the taxpayer in a non-arm's-length transaction (both median and mode 5).

To compare the results for the tax teachers and the tax practitioners, Chi-square tests were conducted to examine whether their responses were independent. In order to meet the minimum statistical requirements, the five-level Likert scale was recoded into a three-level scale (i.e., disagree, neutral, and agree). No recoding was possible for the treatment of unused capital losses for the corporate taxpayers and, therefore, this category was ignored for the purpose of the Chi-Square test. By performing these transformations, the expected cell count did not exceed the 20% empty cell limit.

Table 4.31 Chi-Square for tax structure and tax rates by Group (n=175)

	Chi-Square	**Cramer's V**
1. Unused capital losses for individuals	1.387	
2. Unused capital losses for corporate taxpayers	N.A.	
3. Capital loss as a deductible expense	1.392	
4. Transfer of company CGT credit	2.015	
5. Measure for anti-avoidance	6.148*	0.189

Note: N.A. = no Chi-square test was conducted.
* $p < 0.05$

Table 4.31 reveals that no significantly different response was found, except on the measure for anti-avoidance. Although all the tax experts agreed with the application of the anti-avoidance rules for arm-length transactions, the tax teachers tended to have a stronger level of agreement (median 5) than did the tax practitioners (median 4). Cramer's V statistic is about 0.189 which suggests a small association between the issue and the type of tax expert.

4.7.3 Repeal of current legislation

Table 4.32 Abolition of existing tax legislation after CGT introduction (n=175)

Do you think the following section of the legislation should be repealed if CGT is introduced	Mean*	Median*	Mode*
• Accruals rules	3.38	3	3
• CD 1 land transaction	3.71	4	5
• CD 4 personal property	3.65	4	5
• Controlled foreign company (CFC) and foreign investment funds regime (FIF)	3.52	3	3
• Gift duty	3.65	4	5

*ranging from 1 = strongly disagree to 5 = strongly agree

Question 3-13 of part three of the questionnaire asked the respondents about the abolition of existing tax legislation if a CGT were introduced. The result is shown in Table 4.32. The tax experts agreed that the gift duty, section CD1 of the 1994 Income Tax Act, land transactions and section CD4 personal property of the 1994 Income Tax Act should be repealed if CGT were introduced (median 4). However, they had neutral opinions about accrual rules and the CFC regimes (median 3). It is also noted there were about 10 missing responses for each of these 5 sub-questions. It was assumed that the respondents might be reluctant to answer the last part of the questionnaire.

Chi-Square tests were conducted to test whether the responses for the tax teachers and the tax practitioners were independent, but in all cases there were no significant differences in responses between the groups.

4.7.4 Comparison

Table 4.33 Frequency in percentage for perception of tax structure, tax rates and unused capital loss by CGT proponents, opponents and neutral tax experts (n=160)

Structure	**Proponents**		**Opponents**		**Neutral**	
	Yes (%)	No (%)	Yes (%)	No (%)	Yes (%)	No (%)
Part of income tax	54.3	45.7	42.9	57.1	66.7	33.3
Ordinary income tax rates	56.5	43.5	32.2	67.8	60	40
Carry forward unused capital loss for individual	63.8	36.2	55.7	44.3	83.3	16.7
Carry forward used capital loss for corporate taxpayers	76.6	23.4	67.8	32.2	83.3	16.7

Table 4.33 compares the frequency percentage for the CGT proponents, opponents and neutral tax experts regarding their perceptions of the tax structure, tax rates, and treatment of unused capital loss at the individual level and at the corporate level. The majority of CGT (57.1%) opponents considered CGT as a separate tax while the majority of the neutral tax experts (66.7%) supported the implementation of CGT as part of income tax system. Only a slight majority of the CGT proponents had agreed that CGT should be part of income tax. Regarding the tax rates, the majority of the CGT proponents (56.5%) and neutral tax experts (60%) agreed that capital gain should be taxed at the ordinary income tax rates. In contrast, the majority of the CGT opponents (67.8%) opposed such an idea. These findings supported the notion that the CGT proponents and neutral tax experts preferred a consistent approach on the taxation of capital gains and the taxation of ordinary income, while the CGT opponents supported a differential treatment favouring preferential tax rates on taxation of capital gain.

For the treatment of unused capital loss, all tax experts generally agreed that unused capital losses should be carried forward to the following financial years. It is noted that only a slight majority of the tax practitioners (55.7%) supported the carrying forward of an individual's unused capital losses, while the remaining 44.3% supported allowing a tax refund on unused capital loss instead.

Table 4.34 Median and mean scores for other practical issues by CGT proponents, opponents and neutral tax experts (n=160)

CGT preferences	**Proponents**		**Opponents**		**Neutral**	
	Median	Mean	Median	Mean	Median	Mean
Capital losses as a deductible expense	**5**	**4.17**	**5**	**4.16**	**4**	**3.5**
Transfer of company CGT credit	4	3.85	4	3.86	4.5	3.83
Market valuation for anti-avoidance	4	4.1	4	3.53	4	3.43
Abolishment of the existing legislation on:						
Accrual rules	3	3.19	3.5	3.48	3	3.17
Land transaction	4	3.7	4	3.63	5	4.17
Personal property	3	3.51	4	3.59	5	4.17
Controlled foreign company and foreign investment funds regime	3	3.37	4	3.65	3	3
Gift duty	4	3.57	4	3.74	4	3.67

*ranging from 1 = strongly disagree to 5 = strongly agree

Table 4.34 compares the median and mean for the CGT proponents, opponents and neutral tax experts regarding their perceptions of other practical issues such as deductibility of capital loss against income, the transferability of company CGT credit to the individual shareholders, market valuation for arm's-length transaction, and the abolition of five major tax laws. Both CGT proponents and opponents strongly agreed that "capital loss should be regarded as a deductible expense which can be set against gross income" (median 5 and highlighted in Table 4.35). Also, they agreed that "CGT paid at the company level should be transferred to the shareholders as CGT credits" and "deemed market value should be applied on the disposal for non-arm length transactions" (median 4). These results confirmed that they preferred a neutral tax system where deduction of capital loss against income was allowed and CGT credit passed to individual taxpayers. Moreover, they agreed with the importance of the provision of an anti avoidance measure to stop taxpayers from manipulating the income tax base and CGT.

Regarding the abolition of existing legislation, both CGT proponents and opponents agreed that the gift duty and section CD1 land transactions should be repealed if CGT were introduced (median 4), while they were neutral about abolishing the accrual regime (median 3). However, they had mixed opinions about abolishing section CD 4 regarding personal property, and controlled foreign company regimes. In general, the CGT opponents supported the repeal of both pieces of tax legislation while the CGT proponents were neutral about the issues.

Chi-Square tests were conducted to examine whether the responses of the CGT proponents and opponents were independent. In order to meet the minimum statistical requirements, the variables – tax rates and the deductibility of capital loss – were recoded into a two-scale category. Once these transformations were performed, the expected cell count of the CGT practical issues did not exceed the 20% empty cell limit.

Table 4.35 Chi-Square for CGT practical issues by CGT proponents and opponents (n=153)

CGT practical issues	Chi-Square	Cramer's V
Tax structure	1.576	
Tax rates	7.39**	0.236
Unused capital loss (individual)	0.838	
Unused capital loss (corporate)	1.14	
Deductibility of capital loss	0	
Transfer of company CGT credit	1.66	
Market valuation for non-arm-length transaction	6.082	
Abolition of existing legislation		
• Accrual rule	3.978	
• Land transaction	1.601	
• Personal property	4.837	
• Controlled foreign company regime	2.748	
• Gift duty	3.239	

Note: **$p < 0.01$

Table 4.35 reveals significant differences in responses to the tax rates (after recoding) at the $p < 0.01$. Cramer's V statistic is about 0.236 which suggests a slight small to medium association between tax rates and the tax experts' CGT adoption decision.

4.8 Accrual CGT: Practical issues

Part 2 of the questionnaire set out to explore practical issues surrounding an accrual-based CGT. It covered issues such as valuation and liquidity problems. The result is summarised in Table 4.36.

Table 4.36 Valuation and liquidity of an accrual-based CGT (n=175)

Do you think an objective market price is obtainable for the following assets?	Mean	Median	Mode
• Commercial property	3.58	4	4
• Collectables e.g., jewellery, stamps	2.54	2	1
• Farms	3.45	4	4
• Financial instruments (listed) e.g., bonds and capital notes	3.68	4	4
• Intangible assets e.g., patents and copyright	2.39	2	1 & 2*
• Personal-use property e.g., home appliance and private car	2.56	2	1
• Residential property	3.35	4	4
• Shares in a listed company	3.81	4	5
• Shares in a small company (non listed)	2.51	2	2
Do you think taxpayers will suffer liquidity problems under an accrual-basis tax because they have not yet converted the gain to cash?	4.57	5	5

Note: ranging from 1 = strongly disagree to 5 = strongly agree
* Multiple modes exist.

The respondents generally agreed that an objective market price should be obtainable for commercial property, farms, listed financial instruments (e.g., bonds and capital notes), residential property, and shares in listed companies (median 4). However, they disagreed that the market values for collectables, intangible assets, personal use property and shares in a private company could be measured in an objective manner (median 2).

In respect of the liquidity problems of the accrual-based CGT, the respondents strongly agreed that "taxpayers will suffer liquidity problems under an accrual-basis tax because they have not yet converted the gain to cash" (median 5 and mode 5).

Chi-square tests were conducted to examine whether the responses of the tax practitioners and tax teachers were independent. In order to meet the minimum statistical requirements, the five level Likert-scale was recoded into a three level scale (i.e. agree, neutral and disagree) for farms, financial instruments, and shares in a listed company. Then the variable commercial property was further recoded into a two-level Yes/No category. No further recoding was possible for the variable – liquidity problems. When this transformation was performed, the expected cell count of the asset valuation variables did not exceed the 20% empty cell limit.

Table 4.37 Chi-Square for asset valuation under accrual-based CGT by Group (n=175)

Type of asset	Chi-Square	Cramer's V
• Commercial property	6.196*	0.19
• Collectables e.g., jewellery, stamps	6.023	
• Farms	6.914*	0.201
• Financial instruments (listed) e.g., bonds and capital notes	3.802	
• Intangible assets e.g., patents and copyright	8.287	
• Personal-use property e.g., home appliance and private	13.604**	0.282
• Residential property	9.966*	0.241
• Shares in a listed company	6.401*	0.193
• Shares in a small company (non-listed)	6.128	
Liquidity problem	N.A.	

Note: N.A. = No Chi-Square test was conducted
*p < 0.05, **p < 0.01

Table 4.37 shows that significantly different responses were evident for the tax teachers and the tax practitioners regarding the valuation of commercial property, farms, personal-use property, residential property and shares in a listed company. For valuing these assets, with the exception of personal use property, all tax experts agreed that an objective market price should be obtainable. In general, the tax teachers provided higher scores than did the tax practitioners.

However, there were statistical significantly differences in their responses in regard to the valuation of personal-use property, at $p < 0.01$. The tax practitioners disagreed on the issue while the tax teachers gave neutral opinions.

Cramer's V statistic is about 0.2 for the valuation of commercial property, farms and shares in a listed company, which suggests these variables were slightly statistically associated with the type of tax expert. In contrast, the Cramer's V statistics for personal-use property and residential property are 0.282 and 0.241 respectively. This result suggests that there is a relatively modest association (small to medium) between the variables and the type of tax expert.

4.8.1 Alternative method for accrual CGT

In Question part 2-2 of the practitioner survey, they were asked to choose an alternative for taxing capital gains when it was not possible to value an asset in an objective manner. This question was not posed in the tax teacher survey. Five options were provided. The result is summarised in Table 4.38.

Table 4.38 Alternatives for an accrual-based CGT – tax practitioners only (n=147)

Statement	**%**
What action should be taken to tax the accrual/unrealised capital gain when an objective market price of an asset is not available?	
• No CGT i.e., exempt such a gain	46.8
• A realisation-based CGT	31.9
• A realisation-based CGT plus use of money interest at inflation rate	9.9
• A realisation-based CGT plus use of money interest at internal rate of return of the asset	2.1
• A realisation-based CGT plus use of money interest at risk free return rate	9.2
Total	100

About half (48.8%) of the tax practitioners preferred an exemption i.e., no CGT on the gain. This preference was followed by a realisation-based CGT (31.9%) which was chosen by more than a quarter of the respondents. Very few respondents opted for the use of money interest methods.

4.8.2 Comparison

Table 4.39 Median and mean scores for practical issues of an accrual-based CGT by CGT proponents, opponents and neutral tax experts (n=160)

CGT preferences	Proponents		Opponents		Neutral	
	Median	Mean	Median	Mean	Median	Mean
Objective market valuation for:						
• Commercial property	4	3.67	4	3.4	4	4
• Collectables	3	2.73	2	2.37	3	2.71
• Farms	4	3.55	4	3.24	4	3.86
• Financial instruments	4	3.82	4	3.48	4	4
• Intangible assets	3	2.69	2	2.14	2	2.43
• Personal-use property	3	2.75	2	2.37	4	3.14
• Residential property	4	3.35	4	3.22	4	3.86
• Shares in a listed company	5	3.98	4	3.61	4	4
• Shares in a small company (non-listed)	3	2.65	2	2.37	2	2.43
Liquidity problems	5	4.46	5	4.67	5	5

*ranging from 1 = strongly disagree to 5 = strongly agree

Table 4.40 compares the median and mean for the CGT proponents, opponents and neutral tax experts regarding their perceptions of the practical issues of an accrual-based CGT. All tax experts strongly agreed that "taxpayers will suffer liquidity problems under an accrual-based tax because they have not yet converted the gain into cash" (median 5). For valuation, they agreed that an objective market price should be obtainable for commercial property, farms, financial instruments, residential property, and shares in a listed company (median 4 or above). However, they had mixed opinions about the objectivity of the valuation for: collectables, intangible assets, personal-use property, and shares in a non listed small company. It is noted that the CGT proponents were more optimistic regarding the objective valuation of the assets than were the others as they never disagreed about valuing the assets in this way. These results confirmed that assets could be fairly valued every year if an accrual-basis were introduced. Nevertheless, tax experts generally opposed an accrual-based CGT because of the liquidity problems. They often wrote negative comments beside the questions about the accrual-based CGT in the completed questionnaires. A similar attitude was found in the interviews. Further discussion of the accrual-based CGT will be given in Chapter 5.

Chi-Square tests were conducted to examine whether the responses of the CGT proponents and opponents were independent. In order to meet the minimum statistical requirements, the variable – valuation for shares in a listed company was recoded into a two-scale Yes/No category. The distribution of the responses for liquidity problems variable was heavily skewed to the "agree" side and no further recoding was possible. Therefore, no Chi-Square test was conducted for this variable. Performing these transformations meant the expected cell count of the CGT valuation issues did not exceed the 20% empty cell limit.

Table 4.40 Chi-Square for asset valuation under accrual-based CGT by Group (n=175)

Type of asset	Chi-Square	Cramer's V
• Commercial property	3.895	
• Collectables e.g., jewellery, stamps	4.158	
• Farms	4.705	
• Financial instruments (listed) e.g., bonds and capital notes	3.323	
• Intangible assets e.g., patents and copyright	7.925	
• Personal-use property e.g., home appliance and private	11.463*	0.277
• Residential property	0.871	

Type of asset	Chi-Square	Cramer's V
• Shares in a listed company	0.618	
• Shares in a small company (non listed)	2.121	
Liquidity problem	N.A.	

Note: N.A. = No Chi-Square test was conducted
*p < 0.05

Table 4.40 reveals significant differences in responses for valuing personal-use property. Cramer's V statistic is about 0.277 which suggests a small to medium association between the valuation of the asset and the tax experts' CGT adoption decision.

4.9 Perceptions of CGT model

4.9.1 Perceptions of CGT by all tax experts

This section reports the tax experts' overall perception of a CGT model by summarising all the responses to the survey instruments. The conceptual framework is illustrated in Diagram 4.1 on page 194.

Generally, the results confirmed that the tax experts supported the current hybrid income tax system rather than a comprehensive CGT, even though they agreed that the lack of a comprehensive CGT could provide more significant tax planning opportunities. They also considered that any CGT tax system should include the following essential features: 1) deduction of most costs (except for contingent liabilities and repair and maintenance expenses), 2) provision of all tax preferences such as adjustment for inflation and general exemption for small gains, 3) taxing capital gains on disposal of rental home and land improvement, while excluding gains on disposal of main residence, personal-use property, collectables and business goodwill, and 4) application of only one CGT event for termination of tax residency and rollover relief for a number of situations (such as business relocation, company incorporation, involuntary disposition, renewal of a lease agreement and transfers of assets between related parties). However, a closer analysis of these results with the supplementary information provided by the tax experts revealed the fact that the preferred tax model was simply an extension of the status quo tax system, which was often referred to by the tax experts as a "New Zealand-style CGT" or "New Zealand hybrid income tax system". A number of tax experts supported a CGT with the assumption that the tax should be limited to developers/traders only. This trend was particularly evident in their responses to the taxation of rental homes and personal-use property. From their perspectives, capital gain should be taxable only if the taxpayers had an intention to make a profit.

The results also showed the significance of taxation, in the tax experts' decision making process, on the disposal of real estate property, personal-use property, and collectables. Overwhelmingly the experts were opposed to these assets being taxed for CGT purposes. However, it is noted that the tax experts were uncertain or neutral about the application of a number of the CGT realisation events. This uncertainty was reflected in their difficulty in understanding these technical aspects of the CGT system, particularly when specialised CGT knowledge was required.

Furthermore, the findings revealed some practical issues of implementing an accrual-based CGT. The strong opposition to this accrual-type of CGT was mainly due to the liquidity problems. Nonetheless, the finding showed that the tax experts generally agreed that most of the assets could be fairly valued annually, which was contrasted to the traditional view that objective market value was generally not feasible.

4.9.2 Results of the comparative analyses

To identify the major factors behind adopting a CGT, two major comparisons were conducted to explore the similarities and differences in responses between the CGT proponents and the opponents. Diagram 4.2 on pages 195 and 196 summarises the key findings of the comparative analyses under seven major categories: 1) general CGT issues, 2) asset coverage, 3) computation of cost base, 4) CGT events, 5) CGT preferences, 6) issues about the integration with current tax legislation and 7) accrual-based CGT. Important factors are highlighted in the diagram.

The most interesting feature of Diagram 4.2 is the large number of similarities in the responses between the proponents and the opponents. In particular, most of their responses were identical for the CGT issues in the three categories: computation of cost base, issues about the integration with current tax legislation and the implementation of an accrual-based CGT. However, they showed significant differences in their responses to the general CGT issues, asset coverage, and the application of CGT events. These are discussed below in detail.

4.9.3 General CGT issues

Responses from the CGT proponents and opponents to the general CGT issues relating to the ability of taxpayers to engage in taxing planning activity tended to confirm the observation, made in 4.9.1 above, that the tax experts generally agreed that the lack of a comprehensive CGT would provide more significant tax planning opportunities. However, the CGT proponents perceived the CGT more positively than the opponents did as the proponents tended to agree with the benefit (the clarification of the income/capital distinction) and disagree with the negative effect of the tax (double taxation effect). Also, there were significant differences in their views about the equal treatment between income and capital gain. On this area, the opponents tended to be against it.

4.9.4 Asset coverage

The CGT proponents and opponents shared a similar attitude to the exemption of the capital gain on the disposal of a main residence, personal-use property, and collectables. This finding confirmed the observation made in 4.9.1 above, that the tax experts strongly supported such exemptions in a CGT regime. Furthermore, similar levels of support for exemptions were also evident in the interviews. This will be discussed in Chapter 5. This finding has important implications for CGT policy. Many countries that tax capital gains also provide exemptions for these three types of assets. Most frequently, these exemptions are justified on equity and efficiency grounds. All justifications for exemptions have merits, but counter arguments against these exemptions also carry weight. Exemption for certain classes of assets will often create economic distortion as resources in the general economy will tend to flow to those assets or sectors in which tax-free capital gains can be realised. Perhaps this factor explains why some tax teachers preferred the inclusion of these assets. On this issue, significant statistical differences in the responses of the tax teachers and the tax practitioners were found regarding the tax on all gains on the disposal of collectables and a main residence.

Similarities were also found between the proponents and opponents as regards the exemption of the gains realised on disposal of a debt asset and the application of the residence-source rules in international taxation. Their support for the exemption of gain on disposal of a debt asset might reflect the view that such a gain is already taxed by the current Accrual Rule regimes, and, therefore, exemption should be applied to avoid double taxation if a CGT were introduced. Regarding the international taxation, they also agreed on the application of the residence rule so that CGT should apply to foreign assets that were held by New Zealand tax residents. Furthermore, they also agreed that assets held in New Zealand by foreign, non tax residents should be taxable for CGT purposes.

On the other hand, there were large variations in the responses regarding the other types of asset coverage. Statistical significantly differences between the groups were found. The proponents tended to support a broad tax base coverage while the CGT proponents tended to support numerous exemptions for most of the assets. The response figures also show a medium strength of statistical association on the CGT adoption decision when dealing with each of the following assets: farms, bonds, rental homes, shares in a listed company, shares in a small company, and share options. This result indicated that the decision of including these assets for CGT purposes were likely to be associated with their preferred CGT model.

Somewhat surprisingly, nearly half of the CGT opponents supported taxing capital gain on disposal of a rental home. Perhaps more predictably, CGT proponents overwhelming supported the application of CGT on disposal of a rental home. However, as noted in section 4.9.1 above, the support from the CGT opponents might reflect the fact that they preferred the current hybrid income tax system where capital receipts on disposal of a rental property is taxable as ordinary income if the taxpayer had a profit-making intention.

4.9.5 Computation of cost base

There is a strong degree of unanimity on the computation of cost base. All tax experts considered that most of the cost items (such as agent fees, debts, improvement expenditure, interest, legal fees, value of property given in acquiring an asset and the purchase price) were relevant to computation of the CGT cost base. It is noted that expenditures such as interest expenses should be included in the cost base only if they are not otherwise deducted as an expense for income tax purposes. It is also noted that the CGT proponents and opponents had mixed feelings regarding contingent liabilities and repair and maintenance expenses. The proponents were neutral or uncertain (median 3) about the inclusion of these two cost items, while the opponents tended to agree with their inclusion. These findings might reflect the controversial debate over 1) the inclusion of contingent liabilities into the computation and 2) the distinction between repairs and improvements. In countries with CGT, contingent liabilities are generally not considered in the computation of cost base, but it is common to include the cost of improvements in the computation. It is suggested that accounting for the improvement and repair expenditures can impose significant administrative burdens on the individual taxpayers. If improvements are included, but repairs are excluded in the computation, then education programmes for individual taxpayers are necessary to help them to distinguish improvements from repairs for CGT purposes.

4.9.6 CGT events

Significant differences in the responses given by CGT proponents and opponents were found in the application of all of the CGT events. The proponents supported the application of about half of the CGT events, but were neutral about the other half. In contrast, the CGT opponents showed a strongly negative feeling about most of the CGT events (“strongly disagree” or “disagree). Perhaps the most striking feature of the comparison was the significant association regarding the CGT adoption decision and application of the CGT events. In 11 out of the 14 CGT events, the Cramer’s V statistics were generally more than or equal to 3 which suggested a medium-strength association between the CGT adoption decision and the preference on the application of a CGT event. In particular, stronger associations were observed for reinvestment in replacement property, termination of a contract, and transfer of assets between related parties. The divergent opinions of the CGT proponents and opponents might explain the tax experts’ uncertainty (median 3) about the application of a number of CGT events found in section 4.9.1 above. This lack of certainty might also create problems associated with drafting consistent legislation in respect of the CGT events.

4.9.7 CGT preferences

All tax experts strongly supported the provisions of indexation and the general exemption for small gains (total capital gains less than $1,000), and moderately supported the provision of tapering relief. However, the provisions for averaging relief, small business exemption, and partial exemption for active assets of small businesses were perceived differently by the CGT opponents. They generally were more positive about the CGT preferences than were the proponents.

All tax experts’ overwhelming support for indexation indicated that they were particularly concerned about the impact of inflation on the tax system. The inflation problem will be discussed in detail in Chapter 5.

Another significant issue is the provision of the general exemption for small gains. It is common for countries with CGT to provide general exemption for small gains. The benefit of a general exemption is that individual taxpayers who have made small gains will be exempted from filing tax returns for CGT purposes. This approach is particularly important in New Zealand because most individual taxpayers are not required to file their tax returns.

As for taper relief, all tax experts showed some support for this provision. The justification for it was that it would reduce the lock-in effect. Generally, the rationale for taper relief is that the longer a taxpayer holds an asset, the greater will be the proportion of the gain that is excluded from CGT.

4.9.8 Integration with current tax legislation

There is some general consensus between CGT proponents and opponents about 1) the treatment of capital loss, 2) transfer of company CGT credit, 3) measure for non-arm-length transactions, and 4) the abolition of the tax law regarding land transactions and gift duty. However, significant differences in the experts' responses were found when it came to setting the tax rates.

All tax experts considered that unused capital loss should be carried forward to the following years. Somewhat surprisingly, they strongly supported (median 5) the idea that capital loss should be regarded as a deductible expense which could be set against gross income. However, as mentioned earlier in 4.9.3, the tax experts (particularly the tax practitioners and the CGT opponents) considered that capital gains and income should not be taxed on an equal basis. The asymmetric treatment of capital gain and capital loss might be explained by their desire to minimise any capital gains tax and at the same time, to maximise the tax loss. It is noted that the neutral tax experts (who were excluded in the statistical comparison because of the small numbers) were less positive (median 4 and mean 3.5) about the treatment of capital loss as a deductible expense.

Furthermore, all tax experts agreed that CGT paid at the company level should be transferred to the shareholders as CGT credits. This measure might be accommodated by reforming the current imputation credit system. For non-arm's-length transactions, they agreed that a deemed market value should apply on the disposal price. This was meant to be an anti-avoidance measure to stop taxpayers from avoiding the CGT by gifting assets away to their related parties.

The CGT proponents had a different view from that of the opponents regarding the tax rates applied to capital gains. They were more inclined to choose the ordinary income tax rates, while the opponents tended to favour preferential tax rates that would be lower than the income tax rates. The problem of setting the tax rates will be discussed in detail in Chapter 5.

4.9.9 Accrual-based CGT

The majority of the CGT proponents and opponents shared the same views on the implementation of an accrual-based CGT. They strongly agreed that there were liquidity problems with an accrual-based CGT. They also agreed on the computation of the objective market price for commercial property, farms, financial instruments, residential property, and shares in a listed company. The only asset about which they had different opinions was the valuation of personal-use property. The CGT opponents tended to disagree with the application of an objective market valuation on personal-use property, while the proponents were more neutral about the issue. These findings supported the observation made in 4.9.1 above that it is difficult, but not impossible, to implement an accrual-based CGT if one can determine the appropriate asset coverage and overcome the liquidity problems.

From the written responses in the questionnaire, it was noted that all the tax experts generally tended to oppose the accrual-based CGT. This finding was confirmed in the subsequent interviews and these findings will be discussed in Chapter 5.

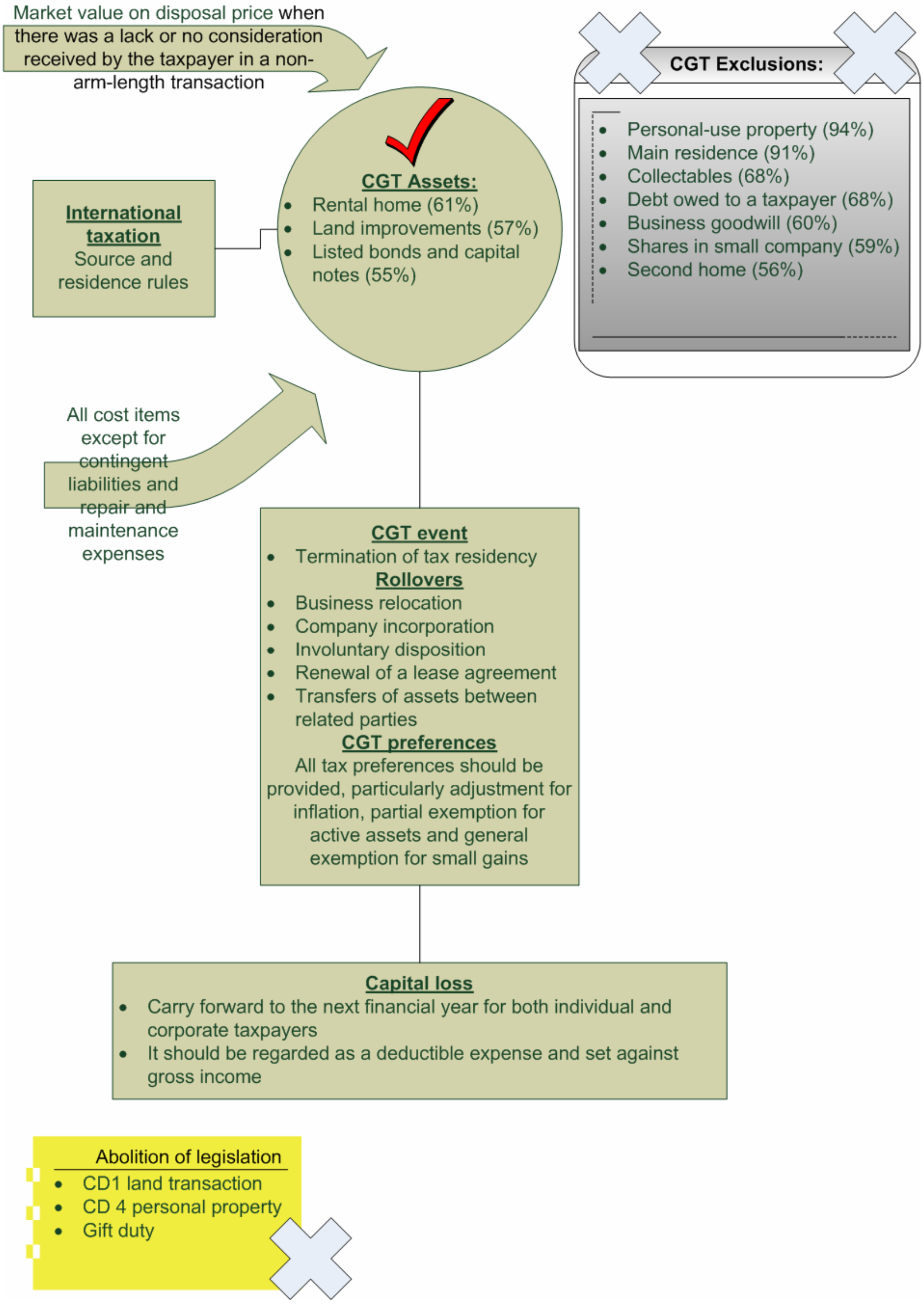
4.10 Conclusion

This research identified some important policy issues that reflected the best possible compromise between the CGT proponents and opponents. In particular, several observations regarding the tax experts' CGT adoption decision were made in this quantitative analysis. It is, however, noted that a number of problems about CGT were not addressed nor resolved, and, therefore, the conceptual framework is still subject to further refinement. The major policy issues arising from the survey are summarised below:

- The lack of a comprehensive CGT creates significant tax planning opportunities in New Zealand.
- Capital gains on disposal of a main residence should be exempt.
- Capital gains on disposal of personal-use property should be exempt.
- The residence-source rules of international taxation should apply to overseas assets held by New Zealand residents and assets in New Zealand owned by foreign non resident taxpayers.
- If applicable, the computation of the cost base in the CGT system should include the following cost items: 1) agent fees, 2) debts to finance the property, 3) improvement expenditure for property, 4) interest for financing the property, 5) legal fees and stamp duty, 6) market value of any property a taxpayer gave or is required to give in respect of acquiring a CGT asset, and 7) purchase price.
- A "deemed disposal" should apply when a taxpayer ceases to be a tax resident in New Zealand.
- Capital gains must be adjusted for inflation for CGT purposes.
- General exemption for small gains should be provided.
- It should be allowable to set capital loss against capital gain. Such a loss should also be deductible against ordinary income. Unused capital losses should be carried forward to the following years.
- While admitting it is difficult, but not impossible, to apply an accrual-based CGT, the difficulty of measuring the market value of the asset in an objective manner might have been overstated. However, it is recognised that liquidity problems would exist if an accrual-based CGT were adopted.

These findings from the quantitative analysis represent a first step towards a theoretical CGT framework, which could enable the formulation of the policy guidelines that might be used if a CGT were considered in New Zealand. The overall tax experts' responses, for each of the important CGT adoption factors, are important when answering the primary and secondary research questions in Chapter 1. This chapter also compares the plotted patterns for more narrowly defined groups of tax experts i.e., by their professional background (teachers or practitioners), and by their CGT adoption decision (CGT proponents, the CGT opponents, and the neutral tax experts). These analyses provide the researcher with an approach for identifying the factors that are important in the CGT adoption decision. The validity of these important factors and other qualitative factors will be examined in the qualitative analysis in Chapter 5.

Diagram 4.1 Overall CGT perceptions



<u>Diagram 4.2(a) Comparison between CGT proponents and opponents</u>

	Similarities	Differences*
1. General CGT issues	**Tax planning opportunities**	• Clarification of capital/ income distinction • Double taxation • Equal tax treatment
2. Asset coverage	• Collectables • Debt owed to a taxpayer • **Personal-use property** • **Main residence** • **Residence rule for overseas assets** • **Source rule for non-residents**	• Business goodwill • Chose in action • Copyrights • **Farms** • Land improvements • **Bonds and capital notes** • **Rental home** • **Second home** • **Shares in a listed company** • **Shares in a small company** • **Share rights and options**
3. Cost base	**All CGT cost items for computation of cost base** Except for: • Contingent liabilities • Repair and maintenance expenses	
4. CGT events		**All CGT events, in particular:** • **Reinvestment in replacement property** • **Termination of a contract** • **Transfer of assets between related parties**

Diagram 4.2(b) Comparison between CGT proponents and opponents

		Similarities	Differences*
	5. CGT preferences	• **Indexation adjustments for inflation** • Tapering discount • **General exemption for small gains**	• Averaging relief • Small business exemptionn • Partial exemption for active assets of small businesses

	6. Integration with current tax legislation	• **Capital loss as a deductible expense**
		• Carry forward unused capital loss to the following years
		• Transfer of company CGT credit
		• Measure for non-arm-length transactions
		• Repealing legislation of:
		  • Land transaction
		  • Gift duty
			Tax rates

	7. Accrual-based CGT	• Objective market valuation for:
		  • Commercial property
		  • Farms
		  • Financial instruments
		  • Residential property
		  • Shares in a listed company
		• **Liquidity problems of an accrual-based CGT**
			Personal-use property

Chapter 5 A qualitative view of the perception of CGT

5.0 Introduction

The purpose of this chapter is to present the qualitative data results. Achievement of this purpose involves analysis of both the written qualitative feedback in the questionnaires and the oral and written data in the subsequent interviews. Thirteen tax teachers and 20 tax practitioners who participated in the questionnaire phase agreed to take part in a second phase of the research project – interviews. The aims of the interviews were: 1) to obtain tax experts' individual perspectives on the New Zealand tax system in general and the current treatment of taxation of capital gains in particular, 2) to explore their ideas about the structure of a comprehensive CGT model and its consequences and 3) to determine why they chose such a theoretical structure for a CGT.

Section 5.1 below provides information about the interview respondents' backgrounds and the procedures for grouping the tax experts according to their choice of a CGT model i.e., CGT proponents and opponents. Section 5.2 looks at the tax experts' own definitions of "capital gain". Section 5.3 deals with the tax treatment of capital gains in New Zealand by exploring issues surrounding the capital/income distinction. The assessment of the adequacy of the tax system in respect of the taxation of capital gains is provided in section 5.4. Section 5.5 looks at the major factors that would affect the tax experts' decision to adopt CGT. Section 5.6 presents the case studies. These reveal the importance of the critical factors in the CGT adoption decision. Section 5.7 provides the analysis of the tax principles for the evaluation criteria.

5.1 Background information

In total, there were 33 interviewees (i.e. 20 tax practitioners and 13 tax teachers). The majority were male, 82% (n=27), and the rest female, 18% (n=6). The geographical locations of the tax practitioners represented a spread across the north and south islands of New Zealand i.e., from Keri Keri (northern New

Zealand) to Invercargill (southern New Zealand); and from Greymouth (south-western New Zealand) to Tauranga (north-eastern New Zealand).

Initially, all tax experts were identified as being either CGT proponents or CGT opponents, with the exception of one tax teacher who was neutral about the introduction of a comprehensive CGT. Before the interviews were conducted, there were 13 CGT proponents (39%), 19 CGT opponents (58%) and 1 neutral tax expert (3%). A rough ratio of 40:60 for proponents and opponents respectively was evident in both tax teacher and tax practitioner interviews. However, after the interviews, 4 CGT proponents (1 tax teacher and 3 tax practitioners) subsequently changed their mind at the end of the interview. As a result, this reconsideration reduced the number of CGT proponents to 9 (27%), and increased CGT opponents to 23 (70%) with the neutral tax expert's position remaining unchanged (3%).

It is important to note that sometimes it was difficult to determine the tax experts' actual preference for a CGT model. There was only a thin line between their CGT support and their anti-CGT sentiments in the borderline cases. Most of the time, the majority were generally "balanced CGT opponents", who did not oppose a comprehensive CGT in theory but rather were concerned about the technicality of a CGT in practice. The reason why four CGT proponents changed their CGT adoption decision provided important information which helped to identify the factors that influenced the tax experts' CGT adoption decision, in general. This finding will be further discussed in Section 5.6.

The demographics profile of the respondents is summarised in Table 5.1 below.

Table 5.1 Background of interviewees

	Tax teachers	**Tax practitioners**
No. of respondents	13	20
Gender		
Male	11	16
Female	2	4
Clients' turnover		
Less than $1 million	n.a.	11

	Tax teachers	Tax practitioners
$1 to 4 million	n.a.	4
$4 million and more	n.a.	5
Location		
North Island		
Auckland	7	6
Hamilton	1	1
Keri Keri		1
Palmerston North		2
Rotorua		1
Tauranga		1
Wellington	3	4
South Island		
Christchurch	2	1
Greymouth		1
Invercargill		2
CGT adoption position (before interview)		
Supported	5	8
Neutral/ Uncertain	1	--
Opposed	7	12
CGT adoption (after interview)		
Supported	4 (-1)	5 (-3)
Neutral/ Uncertain	1	--
Opposed	8 (+1)	15 (+3)

5.2 What are capital gains?

5.2.1 Judicial and economic income definitions

The majority of the interviewees generally considered capital gains as "something that's not income". In principle, they perceived income as the fruit, and capital as the tree. This is the definition used in tax law which is borrowed from trust law concepts. However, they recognised there were inconsistencies around the concept of income used within the tax law paradigm, such as the income from the accrual rule and the foreign investment funds regimes (FIF). They often referred the income derived from the accrual rule and the FIF as "unrealised gains" or "accrual income” which were “specific type of income”. In their opinion, these types of income are regarded as “exceptions” to the general income concept.

One tax teacher commented:

> A capital gain is the sale of an asset that you do not trade or sell. Well, it could relate to a business but it could be a capital asset, building or something that you’re just using as your business premises . . . you are not trading in it . . . it’s a relatively straightforward concept I think. (For gains from the accrual rules and the FIF regimes), well, it’s not a capital gain . . . It’s only a capital gain in relation to the person that you are looking at . . . it falls into one of those (income tax) provisions so it’s not a capital gain.

On the other hand, the majority of tax experts were also well aware of other definitions of income, such as the accounting definition or the economic definition of income. The most frequently cited was the Haig-Simons definition of income. It is the concept of comprehensive income which is the sum of the change in the value of an individual’s (or an entity’s) net wealth (or assets) at the beginning and end of the period and its net cash flow (McLeod Commission, 2001, p. 23). Under this concept, there is no difference between capital gains and income. It is the fundamental principle for comprehensive taxation of capital gains.

One tax practitioner considered the notion of comprehensive income.

> [I am] more comfortable with the first one (the fruit and tree analogy) . . . but I suspect theoretically it is the second one (Haig-Simons’ comprehensive income concept) [which] is the better one . . . that's what I am saying theoretically in my heart. I’d say that's the better one because there is no distinction. If you are looking at an individual’s net worth at two points in time then the increase is income for them. But then, I would want a whole lot of deductions from that because I want to deduct the costs of you living or surviving for that period. [Costs] between the two would have to be deducted because it wouldn’t be fair to pay tax on that.

However, most tax experts considered that it would be "unfair" if the tax system taxed comprehensive income, despite having awareness that comprehensive income captured the underlying economic activities of a taxpayer. A CGT opponent, who was a tax practitioner, stated that:

> I don't think that would be fair . . . because with the tree and the fruit thing, the farmer has to put a lot of money [into] growing that tree and pruning it and labour on everything. And, the risk that nobody is going to buy that fruit next year, so all those risks . . . (The branch of a tree) is an accretion to the capital value and I see that as a very separate thing to be taxed in a different way, or not taxed at all as the case may be.

Despite the popularity of the comprehensive income concept amongst the CGT proponents, some of them considered the comprehensive income concept unfair. One tax practitioner mentioned the problem of inheritance under a comprehensive income tax system.

> I feel more comfortable with the concept of the income being the fruit of the tree, and the tree being capital. I do not agree that movement in wealth should be taxed as income . . . Now do you classify an inheritance, for example, if my father died and he left me $500,000, it is an inheritance, it will increase my wealth at the end of year one, compared to year zero, and if you have a comprehensive wealth tax in that you say wealth at year one less wealth at year zero . . . But (that) increase is income and that will be taxed, then I don't agree. . . In that system and that's what I don't agree with. What I think is that we have an income tax, we should have an income tax, and then we have some method to impose some tax on the capital gains.

5.2.2 Incomprehensible income concepts

Moreover, it was observed that there was a collision between the tax ideology and economic principles. This conflict often complicated the incompatibility relationship between the income definitions of tax law and the economic comprehensive income. At the early stage of the interview, all interviewees were asked to define the terms “income” and “capital”. They would answer the question by referring to the fruit tree analogy without hesitation. Their thinking paradigm changed from a legal perspective to an economic logic after some discussion about controversial tax issues such as taxation of residential property. To justify their statements, they often used economic concepts like efficiency and neutrality, seeing capital gains as part of the comprehensive income. But when the definition question was asked a second time, they seemed to hesitate and thought again about the definition of income.

This confusion between the two concepts can be illustrated in the following conversation in an interview session.

(Note: This tax teacher had adopted the apple and tree analogy at the early stage of the interview.)

Interviewer:	[Regarding] the revenue and capital definitions, are you more keen to agree with the comprehensive income definition or just the apple and tree definition of income? Which one do you prefer?
Tax expert:	Well I probably . . .
Interviewer:	I am thinking you are more on the balance sheet approach because…
Tax expert:	Yes, I think so. Yes.
Interviewer:	But then you mentioned that income would be like apples?
Tax expert:	It comes from the original, from the tree, the tree from the assets.
Interviewer:	So you prefer the apple-trees definition?
Tax expert:	Um
Interviewer:	Because in the questionnaire, you agreed capital gains and income should be treated equally?
Tax expert:	[sigh] Yes I do. I don’t think….[sigh]

[Pause for 5 seconds and interviewer changed topic]

It is suggested that tax law is "incomprehensible", which parallels the concepts discussed in Prebble's work (Prebble, 1993). Tax law is a human construct, just like "fiction". Tax law is made to constrain human actions. On the other hand, the laws of economics govern human behaviour to optimize allocation of available resources to satisfy people's wants. The relationship between the law and the underlying economic activities is vague and confusing. In order to make the laws effective and efficient, the Government attempts to narrow such a relationship by making its tax laws reflect the substance of economic activities within its jurisdiction. However, the main objective of tax law remains "to raise money, not to facilitate the economy" (Prebble, 1993, p. 18). It is these conflicting objectives that make tax law incomprehensible. As in Prebble's words, "the problems of tax law arise from the attempt to fit rules of law around natural facts of economic life. The problems are insoluble, but tax law purports to solve them" (p. 17).

In response to the definition question, one tax teacher commented:

> [Depending on the] accounting arguments or whatever you want to look at, we don't actually know what the topic is and yet we're trying to look at it. We're trying to justify things assuming we actually know what they are. If you go and talk to an economist, they'll tell you something quite different about what income is.

This definition problem is further complicated by inconsistent tax ideology taken from overseas CGT experiences. As suggested by Evans and Sandford (1999), "different political cultures, both between and within countries, led to different emphases on each of these objectives and different CGT regimes" (p. 401). As such, there is no international guidance on capital gains. One interviewee commented that:

> There is no international guidance on capital gains whereas there is one in income tax because we know the standard, we know there's model treaties and negotiations, but you don't see capital gains dealt with very much in international agreement.

Since the definition of income is incomprehensible in tax law, it creates some difficulties in distinguishing the differences between capital items and income items. The issues surrounding the capital/income distinction will be discussed in the next section.

5.3 Capital/income distinction

5.3.1 Artificial distinction

Of the total of 33 interviewees, 15 (about half of them) considered that the distinction between capital and income was not clear, 11 were neutral about the issue or did not comment on the issue, and the remaining 7 thought the distinction was a clear one. In general, the tax experts, particularly an overwhelming majority of the tax teachers, considered that the distinction was artificial and that it was simply a human construct.

Since the Income Tax Act does not define the terms "capital" and "capital gain", this lack of clarity has left it to the court's discretion to decide the true nature of a transaction i.e., whether it is a taxable income or tax-free capital gain, a situation which has led to lengthy litigation. One tax teacher discussed the problems of the capital/income distinction.

> You look at a lot of our tax cases at the moment, if they are not GST cases… it's usually something over the revenue capital boundary type issue, and it may or may not have tax avoidance in it, so I see that as a major problem in the current tax system.

One of the problems of the capital/income distinction comes from the interpretation of the Income Tax Act and its lack of certainty. One tax practitioner compared the New Zealand tax system with the United Kingdom tax system. He stated:

> I suppose if anything, from the UK where a receipt is either taxable as income or capital, with certainties you are taxable somewhere and you can normally find it in the legislation where it is taxable. Here you have to exhaustively look through the legislation to see whether it is taxable, and you are left with the assumption at the end that it is not taxable if you can't find anything. There is always

> that doubt that some kind of receipt is still taxable and you haven't looked deep enough to find the statute that makes it taxable.

Similarly, another tax practitioner found that there could be more than one way to interpret a transaction. He commented:

> The thing [that] is the hardest work is interpretation. The boys in Wellington create the legislation. Historically they don't have the imagination to view how it could be used and, therefore, you get a clever lawyer coupled with a clever accountant, to interpret the law in a specific way. The only thing that the government can now do about it is, as I said, if it is actively promoted then those people will get their hands smacked as well when it comes to the penalty, if it's shown to be incorrect, their interpretation of the law. In my mind I think there are probably more than one or two ways of looking at the case law for instance that there are those people that interpret the law and make a package which is obviously avoidance. (Interviewer): You mean it is like a total package like the Wine-box? (end) Yes, something like that. Even that Wine-box situation is almost impossible to understand.

To illustrate the interpretation problem, a tax practitioner discussed the definition of "substantial" in the context of taxation law. If there was no certainty, people tended to interpret the legislation according their own interests. He stated:

> [In] the legislation, they say words like "substantial" and they don't tell you what substantial is, more than "minor", that sort of thing. I mean the [Inland] Revenue has issued papers on what is substantial and what is more than minor. But the values, the tables they produce with the values are completely meaningless, because you can have something that's $15,000 in 1974 was insubstantial and $5,000 5 years ago could be substantial. Now I have made representations about things like that in the past, where they should put a percentage figure and a dollar figure and they should index it over time so people have more certainty. So I think people interpret the legislation almost how they want it [to be]. When it is

> subjective and you have things like substantial to interpret. People will interpret the way they want to interpret it, and they take more risks. Whereas if the legislation says more than $15,000 or more than 5% of the value of the land for instance, people would either fall one side of the fence or the other and there would be no arguments.

In some of the extreme cases, the tax experts admitted that they could not ascertain the nature of a transaction. It was often left to the Court's discretion to decide the true nature of a transaction i.e., whether it was a taxable income or tax-free capital gain. One tax practitioner stated:

> At the end of the day the only certainty you get is going to court and a judge deciding. Before then, nobody can say for certain not even an expert, that something is or isn't taxable when it involves a certain degree of subjectivity that follows from an interpretation of a word in the Tax Act.

5.3.2 Lack of support from the Inland Revenue Department

The problem of capital/income distinction is further complicated by the lack of support from the Inland Revenue Department. One tax practitioner stated:

> I find the interpretation of the statutes very confusing. The Inland Revenue are particularly unhelpful. They never answer technical queries that go to them. Normal response time for any sort of difficult query is 6 months, if ever. I find there is not enough case law to do with the legislation that they introduced because it is a small country, whereas the UK has lots of case law. They have a very large Inland Revenue with many technical departments that you can get answers from.

Similarly, another tax practitioner discussed the procedures for obtaining an opinion from the Inland Revenue, and described how some of the outcomes could be "horrific" for his clients.

> Now I don't know if you’ve seen the questionnaire form for the IRD that we can submit to get an opinion on whether a land transaction is actual capital or revenue in nature, have you seen that one? It is four pages long, and it says clearly on there, this is only an opinion, it is not necessarily what is going to happen, and even if we have given an opinion we could later on challenge that and attack your position. And then you will be up for penalties and interest. . . And for the rest of the time they are prepared to give an opinion, but if they get their opinion wrong, you are going to pay a penalty in interest as a result. It is really horrific position of the individual or the company. I get my client to sign it, so that it is them that's saying that this is all the information that is correct and I’ll submit it on their behalf and then I wait for an answer. Now we submitted one I think it was February and we still haven’t had an answer back yet. It is the end of the tax year and I have to make a decision on that individual’s property dealings as to whether it is capital or whether it is revenue.

5.3.3 Capital/income distinction in practice

Despite the uncertainty in the capital/income distinction, further examination of the tax experts’ comments reveals that they consider the capital/income distinction has worked reasonably well in New Zealand. One tax teacher stated: “I think the revenue capital distinction works reasonably well in practice even though you get a lot of commentators who say it doesn't.”

Similarly, a tax practitioner revealed:

> At the moment it [the tax system] is working quite well within the framework of New Zealand society. If somebody becomes a property dealer, they are taxable. If somebody becomes a share dealer, they’re taxable. If somebody is a gold dealer or dealing in foreign exchange or hedging funds like future brokerage, they’re taxable. But I would hate to see an inadvertent person to be pulled into the capital gains system.

Though the distinction is working well for simple cases, it may not be the case on some occasions, particularly when a transaction becomes complicated and a large amount of money is involved. One tax practitioner in a major accounting firm provided a summary that described the current environment with regard to the capital/income distinction. He stated:

> Most people would know that if somebody has owned their home for 5 years and then they sell it and make $100,000, that's capital. That's a generally held knowledge. One thing that we have been asked to look at is: A company buys a commercial building and the tenant moves out after 12 months, well they actually pay you a sum of money to move out and terminate their lease and should that termination payment be taxable or be income? Now if that's the only tenant and it's a purpose-built building, then you have got a good argument that's on capital account. Now those are the type of questions that we get but they're referred by our accounting division to us for an opinion, the answer is from an accounting perspective they're looking for specialists' advice. Our role is to answer that question. So, you know, we deal with an issue on that capital revenue on a regular basis . . . we've got specialist knowledge. So, if you don't have specialist knowledge then the distinction between revenue and capital I think is a difficult one, especially if the transaction is outside generally common held principles. [For example, if] I buy some shares and I hold them for a while and then I sell them, most people in New Zealand would think that's capital gain, same with their house, same with their beach property. (Interviewer): So those general [CGT] issues would be quite clear but for other commercial transactions they could be quite difficult [to understand]. (end) Yes.

The distinction between capital and income is vital to the interpretation and application of the Income Tax Act. Some tax experts considered that there were problems with the operation of certain provisions of the Income Tax Act, which taxed capital gains as ordinary income. The assessment of the adequacy of the tax system in respect of the taxation of capital gains will be discussed in the next section.

5.4 What is the extent to which capital gains should be taxed?

The assessment of the adequacy of the tax system in respect of the taxation of capital gains starts by first forming a broad picture of the tax system, and then focusing on more specific issues that the broad picture highlights. This is similar to the approach adopted in field study. During the interviews, the respondents were asked to evaluate the overall tax system and to consider the operation of its individual tax components in detail. The tax experts not only discussed the specific tax provisions that taxed capital gains (such as land transactions and gains from the sales of personal property), but also reviewed a series of other taxes such as fringe benefits tax (FBT), goods and services tax (GST) and the gift duty. Moreover, they talked about compliance issues such as penalties and the provisional tax regimes.

The assessment has two purposes. The first is to determine the extent to which capital gains should be taxed in New Zealand. The second is to examine why the tax experts favour a particular model, i.e., the status quo New Zealand-style CGT or a more comprehensive CGT, and to identify the major factors influencing such adoption (the second objective will be addressed in section 5.5).

It is important to note that there is no comprehensive CGT in New Zealand, yet the Income Tax Act includes certain types of income, which are regarded as "capital gains" in the ordinary sense for tax purposes. These specific provisions are found in Part C of the Act, which charge certain capital gains such as receipts from the land sales, gains from the sale of personal property, etc. The said legislation sometimes redefines the capital/income boundary.

The tax experts' comments that related to the specific tax provisions are grouped into the following subsections: 1) taxation of land, 2) negative gearing, 3) taxation of personal property, 4) international taxation, 5) the Risk-free Return Method (RFRM), and 6) the Accrual rules. It is noted that the tax experts briefly talked about other tax provisions too. However, most of the tax experts were neutral or were not in a position to comment on these issues because only a minority of their clients were involved in those tax provisions. Therefore, there is no separate category provided for the discussions on other tax provisions.

5.4.1 Land transaction

The part of the Income Tax Act that relates to capital gains taxation is most contentious where gains on disposal of lands is concerned. A number of tax experts considered that the legislation was complex and detailed. Some tax experts described the provisions as “draconian” or “harsh”, as they had significant negative impacts on the taxpayers. Moreover, some tax experts believed that the interpretation of the tax provisions regarding land transactions was one of the hardest in the Income Tax Act. As one tax practitioner commented, “it is not very straightforward, you have virtually got to go step by step, you look at all the clauses then you look at the exemptions and it is a real difficult one. In my own experience, I have found it a very difficult one.”

Some tax practitioners considered that the tax law on land transaction was arbitrary and it complicated the capital/income distinction. One tax practitioner stated:

> I think it is incredibly complex and I think it catches certain situations where gain should be on capital account but is often held to be on revenue account. It is very codified. For example, say, I have got land and I have bought it. I am going to use it for a purpose, and it is then rezoned and I make a gain out of that rezoning. You know, there is a formula driven towards determining whether a portion of that gain is attributable to the rezoning and is, therefore, taxable. Also you get a 10 year rule. Now, 10 years is a fairly arbitrary measure of what’s capital and what’s revenue. People don't think in 10 year timeframes. I own shares for example

> that don't need to be held for 10 years to be on capital account, so why should land have to be held on capital account.

Similarly, another tax practitioner discussed the problem in adopting the subjective test of “intention” which is vital in determining the nature of a transaction.

> When it comes to property development and subdivision of land, have you had a look at that Tax Law? Have you tried to figure it out, whether something is capital in nature or income? [laugh] . . . I’ll tell you why, if I buy a section and build a house on it and sell it, is that capital gain or is that income? . . . Intent, okay, so I intended to keep that but my circumstances changed so I had to sell it . . . So once I have sold that one, I buy another section and build it again, with the intention of keeping it . . . Now we are starting to get a bit grey aren’t we?
>
> . . . You have got to be careful with buying and selling properties. If you buy a property with the intention of letting it out and then selling it because somebody is offering you a fancy price, you are caught again. So, you have got to be particularly careful and that's why I advise clients, each of your investment I don't want to know, don't tell anybody the real reason, I say “don't”!

A tax teacher discussed how the tax legislation could affect the price of land and buildings due to the increase in the required rate of return by investors. He stated:

> The effect of CD1 [which is the old provision for taxing land transactions] is so draconian because it taxed your holding gain and these subdivisions schemes tended to be long term in nature. Also the fact that the associated-persons provisions . . . where you can be associated with a land developer and get caught, made it worse. As the result is now, subdivision schemes are not done by many people, and they want obviously a pretty high rate of return to compensate for the tax, the heavy tax of it. . . And, therefore, the

> price of building sections in New Zealand . . . has just driven up the price of land.

Despite the negative impacts of the tax provisions, some tax experts considered that the legislation could served as an anti-avoidance measure. One tax practitioner commented:

> I mean it’s an anti-avoidance provision rather than a capital gain tax, isn’t it? That’s why that section was introduced to try and catch people who, like builders, purportedly bought land privately to build a house on it, and then sold it...

However, some tax experts believed that tax avoidance and evasion were very common in the property sector in New Zealand. One tax teacher discussed the practice of tax avoidance concerning the subdivision of land.

> You see, we don’t care [the nature of the transaction]. Whether you are in a business or not, if you subdivide lands, it is automatically taxable. So a lot of people got very badly caught. Now, the problem was to get the exemption, you had to do it in a piecemeal fashion, because you couldn’t make it in the nature of a business activity. So what happened was a lot of people were doing this over a number of years, so they build a street some of the way and sell off a few sections. When they were all sold, they would extend the street a bit more, chop off another one that’s how most of them go. They don’t do the whole thing, and have 1,000 sites for sale.

Another tax practitioner considered the problems of tax evasion and avoidance.

> There needs to be a stronger definition between who is “a developer” and who is “in the purpose for resale”. That's where most of the avoidance is coming from, because there are definitely people out there that are buying and selling land and rental properties, and doing them up and flipping them, now that should be taxed, if that's the purpose for which they are buying them. A lot of people now are buying them like one a year, and doing them up and selling them, or one every 2 years, just in the hope that they

> don't get caught. (Interviewer): That's evasion, isn’t it? (end) I would think that, but then they come up with, and they’re encouraged by lawyers and accountants to come up with, the reason that they purchased them in the first place . . . No intention for resale as long as it is well documented, like when you go to the bank manager and lawyer that they document the fact that why they are purchasing it.

5.4.2 Negative gearing

One issue related to the taxation of land transactions is the practice of negative gearing. It is a common way to finance a rental property where an investor borrows the maximum home loan (80% to 100% of the cost), but the rental income does not cover the interest on the loan.

There are several advantages for entering into a negative gearing arrangement. Firstly, it provides tax-free capital gain with little or no input of the investor’s own money. Secondly, it enables the high income earners to offset rental losses against other income and to obtain tax refunds. This system is particularly beneficial to those taxpayers who are paying the highest marginal tax bracket. Thirdly, it improves the profitability of an investment. As long as the return on investment is higher than the cost for financing the property, the overall return on equity i.e., rental income plus capital gain is higher than the investor’s contribution to his/her own capital without the funding of outside parties.

One tax practitioner explained how the mechanism of negative gearing worked.

> It is a way to gain income. If the property is kept long term, the mortgage gets paid off enough, the rent income starts to rise and the person does make a profit. So in due course, they do start making a profit but if you buy the property in the right place, it won’t cost as much but you can still get a similar amount of rent. So it doesn't stay that way, but quite often people only keep them as long as they are making a loss and then they collect their capital gain tax free.

Moreover, with an appropriate structure in place, negative gearing can produce a variety of favourable tax treatments for property owners. An tax teacher suggested a possible example of the practice of negative gearing with the use of the Loss Attributing Qualifying Company (LAQC) to buy his own property.

> My wife and I at the moment have a house over here and we've got $150,000 mortgage for example and the $12,000 . . . will be the interest. Whereas if suddenly my AB Co buys this house, it borrows from the bank $300,000 and so it's got an interest cost of $24,000 but this business is actually renting. So that the rent is market rent, it's got to be market rent because otherwise it's a bit arm-length issues . . . I don't know, say $300 a week, so that's $15,000 rent a year, with depreciation and other expenses say $10,000 so it's at a loss of $19,000 and it's a LAQC. So wow, we kept $19,000 loss. That's more than offsets obviously the rent we are paying and we can offset that against the other income.

This tax teacher, however, warned that the Inland Revenue could deem the transaction as a tax avoidance scheme and prohibit the deductibility of the interest expense because this involved the use of LAQC to deduct domestic living expenses. However, this would not be regarded as a tax avoidance arrangement if there were two unrelated persons e.g., friends, who owned two properties and rented them out to each other as private residences.

A tax practitioner suggested another tax structure which involved the use of LAQC and a trust. He also noted that there was a capital gains tax on the distribution of company's profits as dividends. He stated:

> I have been using LAQC companies because after 5 or 6 years of the taxation benefits of owning a LAQC which owns rental properties, the losses that you can claim run out and you start getting into profits. So what I am doing now is when people buy rental properties I get them to buy them in the name of a LAQC,

> and then as the years move on we start selling the shares to Trusts, to a family trust. . . (Interviewer): So the capital gains are realised when you've sold the shares to the trust or when? (end) No, you do gifting, it is just $27,000 a year . . . The property is still sitting in the company. But the company will eventually be owned by the trust. Now when the company sells the property and makes a current gain, I've been going to check up on this for a while and I haven't, I think unless the company is liquidated on sale, then there is a capital . . . an effective Capital Gains Tax on the distribution. So liquidation in the end is the way to do it, but of course if by then the shares are owned by the Trust it is just liquidated to the trust . . . But there is still that little hook there that a lot of people do not understand that Capital Gains Tax is alive and well in companies.

It is important to note that the negative gearing strategy is not without problems, as it can make a profit only if the asset rises in value, i.e., capital gains enough to cover the rental loss. Also there is the liquidity problem as the investor must be able to fund the rental losses until the property is sold.

About one third of the tax experts observed that a number of their clients did not have adequate financial knowledge to invest in the rental property market. These unskilful investors were concerned only with the benefit of the deductibility of tax losses while not fully aware of the poor performance of their property investment. An tax teacher stated:

> . . . the other and it's important, it's a very important point. Now I tell you why I think a lot of people are vulnerable. Some rental property, I said some people do silly things, I actually had some friends that have gone out and bought a rental property and they've a cash deficit of $100 a week . . . Basically the property is not suitable for a rental in that the rent it can earn is too low to the capital value of the property. (Interviewer): That's one or two percent? (end) Something like that. So every week they get in the rent, they get in about $200 a week rent, they're paying out on each

> week $300 in outgoings, mortgage interest, rates, insurance. That's just in a cash basis. In addition of costs, they are claiming depreciation, they've got a whopping tax loss, which [it] is, but they are actually losing in real terms.

He then explained the gain on disposal of a negative-geared rental property could be liable for tax purposes if the return was unreasonably low. This gave rise to doubt regarding the intention of the investor. He continued:

> But it's not going to ever. . . They are on a risk that if they sell it. Don't the facts suggest they bought it with the intention of resale? If you are rational, why would you subsidise your tenant $100 cash a week unless you are [a] charity. The only reason is you are hoping you earn a big enough capital gain at the end of the day to try to offset. Your purpose was to acquire it for resale. Because you are not earning any income off it and the prospect of doing so is very far in the future.

For some commercial negatively-geared investment, investors could be deemed to be "developers" for tax purposes. The same tax teacher provided evidence of a case law that could apply to developers. He stated:

> There have been other cases where that was raised about poor returns on a commercial deal . . . Perhaps on 1% return, they bought it, the price they paid for it reflected [the] fact that it was a development site and they put a multi-storey office building on it. Something happened, that didn't happen. They didn't go ahead with the development. They sold the house as they acquired it, as a rental, rent it to students as a kind of a holding and that was held to be taxable. The Court held it, and the commissioner said that's quite clear you are a sophisticated organisation and you didn't buy that to get a 1% return renting out a dilapidated house to students. You bought that as a development site for your trading of your business and you changed your mind. And you didn't go ahead and you sold it off to somebody else and took a gain. That's on revenue

account . . . It wasn’t a true investment in the terms of deriving rental income, so that’s often overlooked.

Despite the tax planning nature of negative gearing, most tax experts did not regard the practice as a tax avoidance. The tax practitioners considered that a significant number of their clients owned more than one rental property. In their opinions, only 20% of those clients who owned property actually speculated in property, and the remaining 80% had genuine purposes such as rental income and saving for retirement. One tax practitioner commented about the current practice of negative gearing.

> Most of our clients have rental property, as well as other businesses, because I have encouraged them into that, because it is a means of making capital gains that are non taxable [laughing]. Now most of those people are just normal people with other incomes. I think if your business set up was to make capital gains, then surely you would be taxed on the capital gains because you would become like a developer. That's where the key to it lies I think, determining whether a person is in the business of making capital gains or making gains out of property, then I think yes they should be. But for the person with a substantial income from other areas, and to make a loss on rental properties and reap the capital gain, I don't see a problem with that, there are not many other ways.

Similarly, another tax practitioner argued that the practice of negative gearing might seem unfair, but she still thought it was not tax avoidance as it was allowed in the tax legislation.

> I wouldn’t call it tax avoidance as such. You buy a rental property, you gear it up as [the] maximum as you can, 100%, you claim a loss, with the view and most of them now are interest only, they are not paying any principle back so that gearing is left for the 10 years you hold the property or 3 years or 1 year and then sell it as a capital gain. You are getting a tax deduction for the interest as well as getting your CGT free. It doesn't seem fair, but I wouldn’t

> regard that as tax avoidance because that is actually in the legislation that capital gains are free and that losses are tax deductible.

5.4.3 Taxation on gains of disposal of personal property

The tax experts often made reference to the principles laid down in sections CB 3 to 5 (or CD4 of the 1994 Act) regarding dealers in properties, acquired for the purpose of resale or a profit-making scheme. Some of them considered that these tax provisions represented a statutory intervention in the taxation of capital gains in New Zealand. One tax teacher commented:

> Section CD4 which was that you will be taxed [in situations] where you're in the business, where you buy with an intention for resale, or where you use the property for a scheme. And I think that was probably the beginning of what could become a capital gains tax, but through inattention it just never did.

Also a majority of tax experts, particularly the CGT opponents, utilised the principles of these tax provisions to support their assertion that the current legislation covered enough "capital gains" in terms of equity, efficiency and neutrality (this will be further discussed in Section 5.5). When asked whether the current tax system covered capital gains adequately, one tax practitioner answered:

> I believe, so yes. If you are a trader in it, you should be taxed. Trader in the product or goods and again it comes back to intention. If you intend to make a lot of money, there is not a lot of problem.

Despite its popularity, some tax experts cast doubt on the effectiveness of one of the tax provisions, i.e. personal properties were acquired for the purpose of disposal. One tax teacher stated:

> You've got, for example, the second limb in the CD4 [which] says "if you acquire property with the intention of resale". That was extremely difficult to apply. Perhaps, I haven't thought this

> through. Perhaps you could abolish that one . . . I think it’s easy enough if you acquire something if you are a dealer. The first one which is an overlap of CD3 [business income] that's easy enough because you’ve got repetition and occurrence, and that's from a factual and evidential perspective. It’s easier to identify. The second one is really difficult. I buy shares, I buy Pumpkin Patch, I sell them 6 months later. I’ve doubled my money, it’s the only time I have ever bought and sold shares. I know that I bought them with the intention of sale. I thought they would go up, I got good advice and they did. But if the IRD come along, I would say “well, I actually bought them for the dividend growth but after six months I needed the money, I pay it off my mortgage and so I sold them, and no I never had the intention of a sale”. So that one is really difficult to enforce and in fact I think for individuals that they don’t . . . I don’t think the IRD probably do enforce [the law].

5.4.4 International taxation

At the time when the tax experts were interviewed, the proposal for a new Foreign Investment Fund (“FI) i.e., the current FIF rules in the Income Tax Act 2007, was still under public consultation. Some tax experts were aware of the proposal but they generally were unwilling to comment on the new rules until the full proposal was released by the Government. Unless otherwise expressly provided, the FIF regime refers to the previous FIF regime under the Income Tax Act 1994.

All tax experts generally found the Controlled Foreign Company (CFC) and the old FIF rules to be “complex” and “confusing”. Moreover, 7 tax experts (all were tax practitioners representing about one third of total practitioners) were not in a position to comment on the international taxation issues as their clients were not involved in any foreign investment. As one practitioner stated: “None of my clients have got more than $50,000 New Zealand dollars (i.e., the exemption threshold), for FIF. So I have no practical knowledge of how to administer the current FIF regime (the old FIF rules)”.

In some extreme cases, one tax practitioner even advised his client to sell all his foreign shares in order to avoid the complication of the old FIF rules.

> I've come across it and I have had to look at it, but I don't have any involvement in it. I had one just recently where, they have shifted their trans-tasman investments base of operations up to Singapore and as a result of that anybody that owned shares in New Zealand is going to be exposed to the FIF regime, so I am telling one of my clients, and he immediately sold them. Problem solved.

Since the rules were complex and confusing, some tax experts criticised the high compliance cost of the CFC and the old FIF rules. One tax practitioner commented on the compliance costs of the rules:

> Under the current rules, I find that our clients are very confused as to why some of the European Union countries are on the Grey List but some are not. The costs of compliance with the CFC and FIF Rules are very high because those rules are very complicated.

Despite its complexity, some tax experts believed that New Zealand simply borrowed the system from other foreign jurisdictions such as America and Australia. The CFC and FIF were utilised as anti-avoidance measures. One tax teacher stated:

> I think FIF and CFC are pretty orthodox stuff. You know, because . . . certainly you know of such in America, they have had controlled foreign corporation legislation, and various other countries in the world did too. So we just modelled on them basically. The FIF and CFC I mean it's very similar to Australia I would suggest. No it's okay. It was all introduced as part of the Rogernomics supply side economics, you know, anti-avoidance, just protecting the taxpayers, no I think it is pretty orthodox internationally recognised stuff. And now they are introducing thin capitalisation and as well as transfer pricing, so it's all part of it.

A number of tax experts criticised the tax treatment on foreign sourced income at a macro-economic level. They found that the tax rules obstructed international labour mobility and hindered skilful incoming foreign expatriates coming to New Zealand. One tax teacher considered the CFC and FIF regimes as a major problem in the tax system.

> I think [it] is a major problem and that's not only for people who are here already, but also I think that is a major disincentive for people coming from off shore when they have to deal with our system. So anybody, who is mobile, is going to reject that as being a legitimate approach, due to that accrual approach.

Similarly, another tax teacher stated:

> So I think people going to invest in New Zealand or to move to New Zealand, might find "oh good, we don't have a capital gains tax system, that's good". But especially if they have got overseas investment and they are moving here, the FIF and CFC regime, I think, is a real problem to them. So yes they might throw their hands up and say "yeah we're not going to pay capital gains tax on our some of our New Zealand property", but they're going to be hit fairly hard potentially on overseas investments, depending on where they are situated.

One tax practitioner complained that some of his clients were experiencing problems entering New Zealand because of the old FIF regime.

> The FIF regime . . . it's inefficient and it creates big issues for returning expats or in particular for Americans. American individuals with 401k investments that are self-managed, that don't fall into the definition of an employee super fund, you end up with a complete mismatch between their exempt system and our system . . . But then the income comes in, at that point in time they haven't received any distribution out of that 401K, but they're actually paying tax here in New Zealand. That makes a huge amount of returning ex pats angry. We have had some who get extremely frustrated by that and these are presumably the type of people that the Government is wanting to attract back to New Zealand. They are really educated, have international experience, have been

> successful, have funds to invest back in our country. So that mismatch is an issue at an individual level, for individuals, not for the corporates.

5.4.5 Risk-Free Return Method

As stated in previous section, the Government was proposing a new FIF regime (which is now effective) at the time the interviews were conducted. The proposal was controversial as it introduced a new concept of the Risk-Free Return Method (RFRM), which is equivalent to the current Fair Dividend Rate method under the FIF regime at present.

A number of tax experts cast doubt on the effectiveness of the RFRM. One tax practitioner considered that the RFRM was unfair.

> You'll get people just complying or not complying. Sigh, there will be no avoidance, it would just be complying or not complying. I know that [RFRM] will happen anyway. It is a bad move because people should be taxed on their income . . . As far as I am concerned people should be taxed on their income, and people have a range of investments in their portfolio. And if one of those investments tends to be in a Grey-List country they're going to get hammered for it whereas if it was a bank in New Zealand, they would just be taxed on the amount of interest that they had received. So it is unfair, but they are going to introduce that anyway.

Similarly, anther practitioner stated:

> I actually think that removing the Grey List is wrong, because you have actually set up 10 to 15 years of an investment pattern, and New Zealand is a small economy. If you look at the Cullen Fund, its investment portfolio is weighted heavily to overseas. I do think there is a bit of social engineering that the government is trying to encourage domestic investment, they got hammered on, they got caught out with Australia and they have fallen back on that one.

> But then if you say you have fallen back on Australia then why not the United States and why not the UK? The same logic applies.

Another tax practitioner predicted that tax evasion for the new FIF would be significant.

> I see that there is a bias towards the Australian market but there is also a movement towards nondisclosure, in that several of my clients with investments in, especially in Europe, are choosing now to adopt the view that says the income from these shares or in the unit trust is already taxed in Holland or in England, therefore I have no moral obligation to allow New Zealand to tax it again because the tax credit rules are too complicated. And they do not want me or our firm to charge them another $500 to do their tax return for no advantage. So costs of compliance there and the tax cost of the new rules are going to drive people underground. There is a wrong decision.

It is interesting to note that some of the tax experts, particularly the CGT proponents, questioned whether the old FIF regime or the new FIF regime (including the RFRM) was a form of capital gains tax. Some tax experts suggested that the regime taxed capital gains, while other considered that the CFC and FIF were anti-avoidance measures and simply “a practical approach to a difficult problem”.

In respect to the taxation of capital gains, one tax practitioner observed the different tax treatment for investments in Grey-List and non Grey-List countries. He stated: “On the Grey-List, you’re only taxed on your dividends and you are not taxed on your capital gains at all. Outside the grey-list, you are taxed on your capital gains and you’re also taxed as they accrue”.

Another tax teacher suggested that the old FIF rule was a wealth tax. He stated: “I am not a great fan of what they did with the FIF rule of the non-Grey List countries where you’ve actually got an unrealised capital gain from them. That's actually like a wealth tax if you are really honest about it. It is a wealth tax.”

On the other hand, one tax practitioner argued that the FIF regime was not a full capital gains tax.

> The FIF regime it is not (a capital gains tax) because if you had a capital gains tax, you might have one that had a different differential rate . . . Whereas with the FIF regime, it all comes into the income basket and the results are horrendous. (A) you are taxing everything at 39% and (B) it's completely anomalous when you look at the regime in other areas. Whereas if you had a capital gains tax, the FIF regime wouldn't necessarily be as harsh because you would get rid of the FIF regime . . . and you'd be taxing everything else on the same basis so people wouldn't see it as being so bizarre, and you would be taxing it maybe at a lower rate . . . Yea so that's, I think that there are parts of the system where capital gains tax would enable you to have a much better tax system generally.

Similarly, one tax teacher observed:

> CFC and FIF are anti-avoidance measures really. I don't regard it as a capital. Well it is a Capital Gains Tax, but it's quite a small part of the tax base. Let me put it this way. I don't think all these added up replace a Capital Gains Tax, definitely not. I don't think they are a good substitute and I don't think they even come close to being a substitute.

Some tax experts became confused with the definitions of "capital gains" and "capital gains tax" in the interviews. After discussing the CFC and FIF rules for about 5 minutes, one tax practitioner said:

> No it is one of the areas I hadn't thought too much about really . . . There is a question in my mind as to whether it is a capital gain . . . What is a capital gain? I never thought of that . . .

5.4.6 Accrual rules

Of the six major specific provisions that charge taxes on capital gains, the accrual rules appear to be the one which attracts the least attention. Eighteen tax experts were neutral or not in a position to comment as most of their clients did not involve any financial arrangement transaction. Some even simply ignored the accrual rules because they did not understand the provisions. For those who had knowledge and experience about the accrual rules, they considered the accrual rule to be “quite complex for the average man in the street”. However, they also thought that the regime was “probably effective and efficient” in practice.

Some tax experts observed there were some distortions in the accrual rules. One tax teacher commented on the unfair tax treatment between the gains and losses of financial instruments due to change the exchange rates. He stated that:

> There is a lack of symmetry on the accruals. All gains are taxable but not all losses are deductible. For example, as an individual investor you buy a foreign currency bond and bad luck is that the interest coupons and the premium or discount you receive upon redemption is less than the amount because of the exchange rates i.e., exchange loss outweighed all those gained. So overall you make a net loss. That loss is not deductible under our tax rules. Now if on the other hand you had made a super profit because the New Zealand dollar had moved in the right direction and devalued, you made a huge gain on this bond and then the whole lot would be taxable.

Another tax teacher revealed that there was a distinction of tax treatments between debt instrument and shares equity. He observed:

> Our tax system currently recognises the debt equity distinction. Obviously because, you know, the financial accruals exclude equity . . . Obviously interest is deductible whereas dividends are not . . . I don't think you are going to get rid of it. It is too entrenched into the commercial world . . . That was part of the policy issue when they introduced accruals . . . I don't quite know

> the theoretical grounds to it. Presumably the deductibility of interests means it's more an efficient form of financing, whereas dividends aren't.

It is noted that the capital/income distinction is removed for the purposes of the Accrual Rules which is different to the other areas of the tax laws (with the exception of the FIF and CFC regimes). When considering the extent to which capital gains were taxed in practice, some tax experts became confused with the definitions of "capital gains" and "capital gains tax" in regard to the context of financial arrangements. The majority of the tax experts generally considered that the accrual rules taxed capital gains, but a minority disagreed. For example, one tax practitioner said:

> I don't agree with the assessment that the Accruals Rules results in a Capital Gains Tax on debenture notes and that sort of thing, because any capital gain there, if you want to use that term, is only a change in the interest rate applicable. It is not really a capital gain at all, not in my mind. The capital gain you talk about in terms of shares for the company, I understand, but I have not thought too much about that.

5.4.7 What is the extent to which capital gains should be taxed?

One major research question was to explore whether capital gains should be taxed more comprehensively than at present. In the interviews, the tax experts were asked "Whether the current tax system had sufficiently covered most capital gains". If that was not the case, the second question was "What was the extent to which capital gains should be taxed under the current tax system".

The answers to the research question varied for three reasons primarily: (a) the various theoretical definitions of income and capital gains, (b) the elusive capital/income distinction and (c) the complex tax legislation, in practice. It is found that New Zealand has developed its own definitions of "income" and "capital gains". This contrasts with the general income approach that capital gains generally are not income for tax purposes. As a result, most tax experts often present very different ways in taxing capital gains. This makes the assessment of the adequacy of the tax system in respect of the taxation of capital gains difficult.

To illustrate the problem of the capital/income distinction, a tax practitioner discussed the extent to which capital gains are taxed in New Zealand.

> Interviewer: Do you agree that in New Zealand we do actually tax capital gains to a certain extent?
>
> Tax expert: You do under the FIF [Foreign Investment Fund regime] and we do under lands
>
> Interviewer: Accrual rule as well?
>
> Tax expert: No I am not so sure about accrual rules. FIF, lands, if I buy anything with the intention of resale, property. We don't tax $500,000 in Telecom shares or a bach at Pauanui, we don't tax that.
>
> Interviewer: Intention for resale – it is actually more like ordinary income anyway. It is not capital gain as such, is it?
>
> Tax expert: But it is still a capital asset.

One tax practitioner explained the concept of a capital gains tax.

> If you take a property developer, for example, in New Zealand, he does actually pay Capital Gains Tax because he is in the business of producing buildings . . . That is his business. Any gain on the sale of what he produced should be taxable. So in theory, we do actually technically have a Capital Gains Tax for people who are in the business of using, producing a capital item. And so you could argue that if you produce anything and you sell it for more than it cost to produce, then that is already taxable.

The tax expert's perception of a capital gains tax was also influenced by the media.

The following shows the discussion with the same tax practitioner about the adequacy of the tax system in respect of the taxation of capital gains.

Interviewer: Do you think the current tax system has sufficiently covered most capital gains?

Tax expert: Yes, but then of course I have read lots of small articles, Letters to the Editor and all that sort of drama, published magazines saying that New Zealand does have Capital Gains Tax and in most of the issues that have been raised, I can altogether see that they are capital gains.

Interviewer: Well, they are capital gains, aren't they?

Tax expert: That's just my opinion

Interviewer: Since they are actually capital gains, so could you describe . . .

Tax expert: I think so, yes. See just going on the Accruals Rules for instance, I think the Accrual Rules regime is a valid regime to have, but I do not see it as Capital Gains Tax.

One tax teacher discussed the issue of capital/income distinction and the taxation of capital gains from a historical perspective. He stated:

> I just think it's an accident the way New Zealand's tax system developed and they had right from the very beginning the equivalent of Section CD4 (taxation on gains of disposal of personal property), which was that you will tax where you're in the business, where you buy to resale, or where you use the property for a scheme. And I think that was probably the beginning of what could become a capital gains tax, but through inattention it just never did . . . I think this is an expansion of the concept of income into what is capital gains. Without any doubt I believe these things are capital gains, and the government has simply decided that it wants to tax those types of gains more precisely.

One tax practitioner, however, stated that the taxation of capital gains tax in New Zealand was a "myth". In the questionnaire, he wrote "To think there is no CGT in NZ at present is a myth – several sections now already tax what would otherwise be regarded as capital transactions – i.e., intention and resale, land disposal etc".

Despite the broad definition of “a capital gains tax”, all tax experts were well aware that “income” under the Income Tax Act included certain items which were regarded as “capital gains” in the ordinary sense. Some tax experts, particularly the CGT opponents, who represent the majority of the tax experts, believed that the current tax system had sufficiently covered “most capital gains”. They considered that “capital gains” were derived from any capital transaction that involved an intention/purpose to resale, profit-making motives or a business dealing with the assets. They sometimes called the current taxation of capital gains as “the New Zealand-style CGT” – a hybrid tax system with a CGT applied to businesses, developers, and traders only. They tended to think that the government should only tax those taxpayers who had an intention for resale or were profit-making for their businesses.

In contrast, for those who considered that the current tax system failed to cover capital gains adequately, they did not regard those types of “income” as “capital gains”. One tax teacher stated:

> I think that the Accruals definitely a Capital Gains Tax . . . And as far as the taxation on land is concerned, there are only really a couple of provisions that are really a Capital Gains Tax. With the land, most of it is on revenue account anyway . . . So land and shares, they are definitely not Capital Gains Tax. You can't say that they are a CGT. The FIF is and CFC are because they obviously work on the unrealised gain, but then that's more of an anti-avoidance. CFC and FIF are anti-avoidance measures really. I don't regard it as a capital, well it is a Capital Gains Tax, but it is just a small part of the tax base. Let me put it this way I don't think all these added up replace a Capital Gains Tax. Definitely not. I don't think they are a good substitute and I don't think they even come close to being a substitute. There are big exceptions on taxation on land and shares. It is really only the accrual rules, that's Capital Gains Tax.

However, it is important to note that even some tax experts realised there was inadequacy in the current tax system. They cast doubt on whether capital gains should be taxed more comprehensively. The same tax teacher further argued:

> All my readings indicate that the problem with Capital Gains Tax is that it is a very inefficient tax. I believe I am a fruit and tree man (the income concept), and I think capital gains if they are to be taxed must be on a realised basis . . . And the capital/revenue distinction, so you know, the distinction is no longer important anymore because everything is taxed.

There were a number of considerations necessary for the effective implementation of a comprehensive CGT system. At the theoretical level, one must resolve the three problems stated earlier, i.e., (a) the various theoretical definitions of income and capital gains, (b) the elusive capital/income distinction and (c) the complex tax legislation in practice. Until these theoretical issues are resolved no firm criteria can be formed for making the CGT adoption decisions.

One tax teacher discussed the theoretical issues about the implementation of a comprehensive CGT. He stated:

> One of the issues is what is income and what is capital gain, or what is capital? I'm just doing some work at the moment and it's on deductibility. But again, I am just going through case after case. It's a slightly different issue. What is capital expenditure and what is revenue or deductible expenditure and I know it is slightly different. But it is a definition problem – the concept of income is partly derived from trust law and income flow and other . . .

The same tax teacher also observed that this definition problem could also be found in countries with CGT. He suggested that a possible solution was to tax capital gains and income exactly in the same way. He continued:

> But I think you'll find that even countries with capital gains taxes are still going to have issues of what is income and what is capital gain, because typically there might be intention of capital gains, there might be a different rates and tapering or it might be other

> things. I guess it only wouldn’t be an issue if capital gains were taxed in exactly the same way as income, no exemptions and I don’t think that's possible. I never thought about it actually . . . I don’t think it would be. Politically I don’t think it would be possible.

Despite the difficulties, some tax experts, particularly the CGT proponents, strongly supported the equal tax treatment of income gains and capital gains. Another tax teacher stated:

> The boundary [between income and capital] is a bit subjective, it tends to vary, depending on which court you go to. I also see the boundary between income and capital as an artificial one. However, there is no logical reason why you should tax income gains but not capital gains especially when you can't really distinguish between the two. But then there are so many difficulties in distinguishing between the two.

It is often the practicality and the political reasons that prevent a tax expert from choosing a comprehensive CGT. It is also important to note that sometimes it is difficult to determine the tax expert’s actual preference for a CGT model. In some cases, there is only a thin line separating their positive CGT statements from their anti CGT sentiments. In general, the majority are “balanced CGT opponents” who do not oppose a comprehensive CGT in theory but rather oppose the technicality of a CGT in practice. The factors influencing their CGT adoption decision are discussed in section 5.5.

5.4.8 Perceptions of a comprehensive CGT

The interviewees were asked to envisage a CGT scenario and to discuss its worst possible outcomes. They were asked to describe, if a CGT were introduced in New Zealand, what kind of core elements should be included in such a tax. Also they were asked to discuss the aspects that should be avoided. Since the majority of the tax experts opposed the introduction of a CGT, some were reluctant to imagine the implementation of such a tax but they were more willingly to discuss the negative aspects of a CGT.

A CGT was generally regarded as “a tax on the profits from the sale of assets”. Since most tax experts considered that capital gains were different to income, a CGT was generally regarded as an extra tax, not an integrated part of the income tax system. They generally considered that a realisation-based CGT would be better than an accrual one. In particular, they were concerned about the huge compliance costs involved getting their assets fairly valued on an annual basis under an accrual-based CGT.

It is interesting to note that the tax experts often stressed the similarities between a CGT and the Fringe Benefit Tax (FBT) – which was referred to as one of the most complicated taxes in the current system. In New Zealand, the FBT raised less than 5% of the total revenue which was parallel with the revenue collected from CGT in foreign countries. Also the FBT was first introduced with an intention to improve the equity of the tax system. This was parallelled with the intention to introduce a CGT. One tax practitioner commented on the vulnerability of a CGT by discussing the operation of the current FBT regime:

> FBT was introduced with a laudable aims . . . because it was to encourage employers to pay the real cost of employing a person in wages that are taxed at source, rather than give them a company car, contribute to their super scheme or whatever the FBT was dealing with. Now in hindsight although it seemed a good idea at the time, again it has become so complicated that I question its worth. In the accounting game, we have an unwritten rule, it is called materiality. If an item in a set of accounts is less than 5% of the revenue then it is not material. So, therefore, any tax like a CGT that is below the 5% threshold then I don't think we should have it . . . We have got two main systems. There is the Income Tax and there is GST. If you want to fiddle about with the tax rate just throw it on the main tax rates and forget about the little taxes because they are only little.

Similar to the problem with a FBT, most tax experts agreed that the compliance issues i.e., more paper work and more complex tax legislation, were the worst possible outcome of a CGT. Also compliance cost would increase dramatically as the tax would bring back into the net a number of individual taxpayers who were earning a salary and were not required to file tax returns under the current tax system. These were the critical factors for tax experts opposing the introduction of a comprehensive CGT (See more discussion in section 5.5).

Despite the unpopularity of a CGT, and its worst possible outcomes, a number of respondents believed that CGT “is something that will inevitably come”, and that “we are the only OECD country that doesn't have CGT, so we are fooling ourselves if we think it won't happen.”

5.4.9 Design features of a comprehensive CGT

When considering the tax design of a CGT, the provisions of tax relief and exemptions were the tax experts’ major concerns. These exemptions include: a) private residence, b) adjustments for inflation, c) general exemption and d) other tax deductions and exemptions.

a) Private residence

The exemption for a private home was the most cited subject in the interviews. All tax experts recognised that the residential property market played a vital part in New Zealand’s economy, and most supported the exemption for private residences. They often considered “equity” and “the importance of private residence” as the major factors for such exemption. One tax practitioner argued that the exemption “was equitable because it was a “New Zealand psyche”- the quarter acre section to own your own home and to strive for something of your own. In her opinion, it was “an absolute insult” to have the private residence taxed.

One tax practitioner discussed the problems in taxing a private residence. He commented:

> There are three big problems; (1) Very few people actually ever sell their house and trade down and use that for living in their later years as a save method. They have a pension and they just don't do it. In the investment theory, it suggests you buy a two million house or whatever you think you can live on in your retirement. And then when you are going to retire, you sell that and buy a $500,000 house and you have half a million. The reality is if you lived in a two million dollar house you are not going to move to a $500,000 house. (2) The second thing of course is it is questionable actually with you realising that gain. (3) But the fundamental issue is you are not going to tax houses because it is just political suicide.

Most tax experts agreed that the exemption of the private residence was essential for political saleability. A number of tax experts recalled the situation when the McLeod Tax Committee suggested applying a risk-free return rate model on taxation of housing. One tax teacher commented “there had been a huge outcry, remember when they talked about the risk free rate, all the main political parties said we will not tax houses yet that's what McLeod wanted”.

In addition, many tax experts realised that a tax on a private residence would mean a substantial increase in compliance cost of the tax system. Nearly all New Zealand families would have to deal with a CGT. As a result, many non-filing taxpayers, such as salary and wage earners, would have to engage with the tax system. This move could contradict the Government’s objective to reduce compliance costs for taxpayers.

However, about half of the tax experts (or 15) realised that people sometimes disguised their investment as the family home. Some tax experts suggested that there should be a ceiling on the exemption for a private residence. One tax practitioner stated:

> I think that the ceiling should be set quite high, so that most genuine home owners would not pay CGT on their own home. But that people who had a private home worth 3 million dollars or more, that there should be a CGT at that level. The reason that I say

> that is because a family home at that level of investment is more of an investment for gain than it is for a house, you know, a roof over the family's head.

One related issue was the taxation on housing other than for private residence. There were diverse views on taxation of a second home. One tax expert discussed the compliance cost and the administrative difficulty of a CGT in respect of the taxation of housing. He commented:

> There are significant issues regarding CGT particularly if there are exemptions for "the family home"- at what value, what is the difference between people who live in a $500,000 family home and have a $500,000 beach house and spend equal amounts of time living in both and someone who lives in a $1 million home at a beach. There are an enormous number of other examples also.

Some tax experts argued that there should also be exemption for rental homes and second home. One tax practitioner suggested: "a second home or a rental home should not be taxed, to allow a family to build up their assets e.g., for their children who would otherwise be living with their parents". In contrast, another tax practitioner considered a CGT should apply to rental properties and no exemption should be given because "tax relief is granted in mortgage interest and other items which private home owners do not get".

b) Adjustments for inflation

Indexation of capital gains was considered equally important by the tax experts. An overwhelming majority of the tax experts agreed that nominal capital gains should be adjusted for the effects of inflation. They also recognised that New Zealand had a history of high inflation rates. In their opinion, an indexation allowance should be provided for most assets, with reference to the Consumers Price Index (CPI), which was regarded as the most appropriate measure of inflation.

One tax teacher discussed the problem of inflation and its impacts on high marginal tax rates from a historical perspective. He stated:

> The fact is we've often had a high rate of inflation, so we've had a situation until probably the late 1980s we've had high marginal tax rates . . . [as] there was no adjustment for inflation in the tax system. So the effective rate the top rate at one stage was 66%, on some transactions could have been over 100% because you didn't take inflation into account . . . So you see at a very hostile kind of situation . . . The public has good reason based on past experience to fear a capital gains tax.

However, another tax teacher argued that since other income was not adjusted for inflation, indexation should not be provided as such allowance would create complexity into the tax system. He preferred the provision of CGT discounts as a proxy for inflation adjustment. The point was stated thus:

> So another question is why do you index? Why should you not pay tax on the gains from inflation? I mean you pay gains, you pay tax on gains from other asset sales and you don't index those, and you don't index shares, increases in the value of shares, so why should you index other assets . . . It's an incentive, you are helping business by allowing indexation. I mean, it's basically an incentive or a tax rebate isn't it? You are reducing the amount of tax. Instead of having indexation, why not just reduce the rate of tax? Why make it complicated? I mean, it makes the whole system complicated.

In contrast, a practitioner argued that the CGT discount and the indexation allowance could be implemented at the same time. He commented:

> Yes indexation. (Interviewer): But then you have got discount already (end). Well I don't see why they are mutually exclusive because, [from an employee's perspective], most wage contracts are indexed. (Interviewer): But our tax system never indexes for inflation (end). No, no. But you've had Capital Gains Tax. If you think about equity, if an employee on a shop floor is doing the

same job that they did, so they are making widgets one year and they are making widgets the next year and then being paid, their wages had gone up . . . if my cost base wasn't adjusted for inflation, you would be taxing more, taxing on the nominal gain.

c) General exemption

Most tax experts suggested that there should be a general exemption. Since a comprehensive CGT taxes gains on all types of assets, they generally agreed that the tax would be complicated to administer as taxpayers are required to keep a record of the costs of all of their assets which could include insignificant personal-use properties. They considered that the taxpayers' compliance costs could be reduced by the provision of a general exemption.

There were different views on the appropriate level of the exemption threshold. One tax practitioner suggested that:

> I think there needs to be a level . . . from an efficiency argument there needs to be a de minimis threshold on something. So what, if ma and pa own their family home and have $200,000 with AMP, what's the point of bringing them into the Capital Gains regime? You are now going to force somebody to file a tax return that currently isn't in the system. Maybe they've both just earned salaries and wages, and get some interest in dividends. They don't need to file a return at this point in time. So you need to work out what's the benefit of making people like that comply. There has to be a level. So if it's 50,000 shares and the family home, there needs to be some, there needs to be a principle residence plus a de minimis level of investment before the regime kicks in. (Interviewer): That means a general exemption, like in the UK? (end) Yes. Even like FIF it's a fifty grander whatever a FIF investment, before they're taxed. It is the same concept because otherwise you are going to drag a whole lot of people in, and all you are doing is imposing a compliance burden for minimal revenue gain.

One tax teacher considered that an econometric analysis would be useful in setting the appropriate level of general exemption. He stated:

> I think there probably should be an exemption for capital gains, an exemption. And you could have a small exemption for income tax generally, because like the way Australia do it they just feed it into the tax calculation . . . I think that's going to be an econometric analysis. You are going to have to do some economic modelling just to see from a compliance point of view, you know, the cost of collecting it and administering.

Most tax experts acknowledged that since a significant number of New Zealanders were salary earners and most of them were not required to file a tax return, the introduction of a CGT would be problematic as it would increase the compliance costs of those taxpayers substantially. However, one tax practitioner argued that this problem might not be as significant as was generally perceived. This was particularly true if a general exemption for small gain were to be provided. The point was stated as follows:

> (Interviewer): With the introduction of CGT they would be likely to grab all the people back to the tax system again? (end). I don't know a lot, because if they own rental properties they are filing tax returns anyway. So the only additional people would be those investing in shares, I would think. Because if you are going to exempt the family home, most people don't have to file a tax return. So there will only be those taxpayers who are personal tax summary people, now they don't file tax returns, wage and salary earners, but only with shares. Because that would be the only additional thing that would be likely to be subject to a Capital Gains Tax . . . I don't know what percentage of the non-filing tax return people have dividend income, and of course you could always have an exemption for it. All these things like de minimis Rules because your capital gain was only a few thousand dollars every year, sure they are going to collect a few hundred tax but is it

> worth the costs to bother to collect that tax and the answer is it isn't really. So you exempt those small taxpayers.

However, one tax teacher was cautious about setting the appropriate level of the general exemption as this would provide an incentive for taxpayers to manipulate the tax system. He stated:

> As soon as you provide thresholds you invite people to actually restructure affairs so different entities are trying to get underneath the threshold. For example, if you set a GST threshold of $40,000, you have got to be careful that they don't have structures to get around the threshold. But certainly it is an issue because capital gains are more than just capital gains for businesses.

d) Other tax deductions and exemptions

In the interviews, the tax experts also discussed the deductibility of capital expenditure and losses. In general, they agreed that capital expenditure and losses must be deductible against capital gains. However, since a significant number of New Zealanders were salary earners and most of them were not required to file a tax return, one tax teacher argued that the introduction of a CGT would be problematic as it would increase the compliance costs of those taxpayers substantially. He stated that:

> The IRD has excluded all the salary and wage earners. Now they'll have to look at a way of bringing those people back in, because you can't have people on the outside, not each year declaring that they haven't got a capital gain to be taxed. Because we've removed them, serious problems would exist if you leave them outside of the net . . . Yes I understand what the annual exemption means. But also the people in Australia are still filing tax returns because they are claiming exemptions or deductions against their income so they're actually ticking the box. Okay I don't have to do anything, whereas in New Zealand we haven't even got them putting the returns in, so it is going to be an issue for New Zealand. If you are going to bring it in, one of those issues will be the whole range of

> people that we’ve justifiably I suppose excluded from the tax system. But it’s also if you are going to introduce them back in, you must allow them to have the ability to claim deductions again, like the school teacher claiming deductions on their home office against their salary. [By doing that] might even help as it should be, you know. But it will actually introduce those people back into the tax system and I wonder about the efficiency from that point of view if we are looking from the government’s point of view.

At the general level, one tax practitioner pointed out that any exemption from a tax would become a tax “planning option” and investment decisions would follow that way. He found that any exemption provision could be “a mine field”. For administrative simplicity, he suggested that the exemption might be set to catch larger transactions only. However, another tax practitioner argued that, from the overseas experience, the complexity of a CGT was often due to the preferential treatment, and concessions given, to certain classes of assets or taxpayers.

It is noted that rollover relief was the least discussed topic in regard to the tax design of a CGT. Only three tax experts briefly mentioned such provision. No further elaboration was given on the choice of rollover and the reason behind the support for the rollover relief. The finding reflected the difficulty the respondents had in making a decision in an imaginary environment of CGT. In fact, rollover and realisation events are specific, technical tax administration issues which require specialised expertise within the discipline of CGT. The main focus on the issues of exemption on private residences and indexation allowances had diverted the tax experts’ attention away from other important administration issues such as the rollover relief. It is submitted that more in-depth investigation is required as overseas experience suggests that rollover is one of the main problems for CGT. The lack of discussion of rollover will undermine the analytic integrity and evaluation framework of CGT.

5.4.10 Summary

This section has provided an overview for discussion about the tax experts' comments on the specific tax provisions concerning the taxation of capital gains. It also reveals the extent to which capital gains are currently taxed in New Zealand. In practice, the tax provisions are designed to be very specific and the extent to which capital gains are taxed depends heavily on the types of assets under consideration. Often tax experts have to exhaustively look through the legislation to check whether an item is taxable, and they are left with the assumption at the end that an item is not taxable if no applicable provision is found. This definition creates ambiguity in the tax system.

Moreover, some of the tax provisions are complex and very hard to understand. These provisions include the legislation concerning the taxation on land transactions, the international taxation, and the Accrual Rules. When dealing with some extremely difficult cases, such as the Accrual Rules, some tax experts simply ignored the provisions as they did not understand the details of the rules.

Further, the specific tax provisions complicate the capital/income distinction in practice. The tax experts clearly had mixed opinions about the definitions of "capital gains" and "capital gains tax". For example, some of them believed that the specific tax provisions were not taxing capital gains, and that they simply caught those taxpayers who were deemed to be dealers in properties or who acquired properties for the purpose of resale. In a broader sense, they considered that these gains were ordinary income and not capital gains. The distinction is blurred even further by the fact that the Accrual Rules have specifically removed the capital/income distinction. Under the Accrual Rules, any gain on financial arrangements is taxed on an accrual basis. This area is different to other areas of the tax laws.

It is evident that the legislation in the past concerning the taxation of capital gains arose piece-meal and frequently in an uncoordinated fashion. The current partial approach to taxation of capital gains by no means constitutes a comprehensive CGT. The problem here is that it is difficult to first assess the adequacy of the tax system in respect of the taxation of capital gains, and then to determine the extent to which capital gains should be taxed in New Zealand. All this is because there are diverse views regarding (a) the various theoretical definitions of income and capital gains, (b) the elusive capital/income distinction and (c) the complex tax legislation in practice. As a result, most tax experts often present very different ways taxing capital gains.

5.5 Identifying the factors for CGT adoption

A careful analysis of 33 tax experts' individual preferred choice of CGT model revealed that there are 23 underlying factors, in both the taxation and external areas, influencing the CGT adoption decision. These can further be grouped into five sub-categories i.e., (a) tax environment, (b) CGT structure, (c) tax evaluation, (d) social and political factors, and (e) international taxation factors. The 23 factors are ranked according to their frequency (as shown by the number of tax experts) in order to determine how large a role each factor has played in the tax experts' CGT adoption decision. The top three factors, which have equal ranking and same scores, are high tax burden, negative political implications, and importance of private residence. These are followed by the factors of equity and complex CGT computation. Details are shown in Table 5.2. The top five factors are also highlighted in bold.

Table 5.2 Ranking of factors influencing CGT adoption

Category	Factor	Frequency (no. of tax experts)	Ranking
Taxation variables			
Tax Environment	**High tax burden**	**33**	**1**
	Gap between theory and practice	15	15
	Mistrust of IRD	12	16
	Black-hole expenditure- non-deductibility of capital expenditure	10	19
CGT Structure	**Complex CGT computation**	**30**	**5**
	Inflation and indexation	29	6
	CGT additional record keeping	22	9
	CGT errors and tax penalty	16	14
	Issues for preferential CGT tax rate	8	20
	Issues for accrual based CGT	5	22
Evaluation	**Equity**	**31**	**4**
	Simplicity	27	7
	Revenue consideration	22	9
	Efficiency and neutrality	21	11
External variables			
Social and political	**Negative political implications**	**33**	**1**
	Importance of private residence	**33**	**1**
	Stopping property speculation	26	8
	Distortion in investment behaviour	19	12
	Increase compliance for small businesses	19	12
	Hindering savings for retirements	12	16
International taxation	Tax harmonization	11	18
	Tax competition	8	21
	OECD’s recommendations	4	23

It is noted that multiple factors may simultaneously affect a tax expert’s CGT adoption decision. Hence, tax experts had utilised more than one CGT factor, and on average, each of them provided two to four factors in an interview. The factors were then ranked inductively created on observations during the interviews. It was not artificially assumed that all these factors were mutually exclusive. A maximum frequency of 33 would be achieved when all interviewees chose the factor.

In general, the taxation variables account for 63%, while the external variables account for 37%, of the total occurrences of the decision factors. At a subcategory level, the social and political factors account for 32% of total occurrence, the CGT structural and evaluation factors each account for 25% and 24% respectively, tax environmental factors 15%, and the international taxation factors 5%. These findings highlight the importance of the social and political factors in the tax experts' decision making process. The accumulated frequency and the percentage in each category are shown in Table 5.3.

Table 5.3 Major CGT factors in accumulated frequency and the percentage

Category	**Sub-category**	**Frequency**	**Percent**	**Accumulated percentage**
Taxation factors	Tax environment	70	15%	
	CGT structure	110	25%	
	Evaluation	101	23%	
				63%
External Factors	Social and political factors	142	32%	
	International tax factors	23	5%	
				37%
Total		**446**		**100%**

The main theme of the clustering is clear: the decision for choosing the way to tax capital gains is significantly affected by non CGT structural factors i.e., the high tax burden in the current tax environment, and social and political factors.

5.5.1 Tax experts' change in mind

The tax experts relied on these 23 taxation and external factors/reasons when choosing a particular CGT model, i.e., the status quo system or a more comprehensive CGT system. The majority of them were "evenly-balanced CGT opponents" who did not oppose a comprehensive CGT in theory but rather opposed the technical problems of a CGT in practice. They often had more than one reason to support their decision, and there was only a marginal distinction between their CGT support and their anti-CGT sentiments. For example, one tax expert perceived the lack of a comprehensive CGT in New Zealand as unfair (the equity factor), but he/she opposed the introduction of a CGT due to the additional filing requirement that would capture the current non-filing taxpayers (the factor of "CGT additional record keeping").

It is noted that four tax experts (one tax teacher and three tax practitioners) subsequently changed their minds at the end of the interviews. Initially, all of them were CGT proponents, but then they changed their minds to become balanced CGT opponents. Their change of attitude was more likely related to the uncertainty of the system rather than the researcher's influence. It is perhaps interesting to note that one of the four CGT proponents had previous exposure to and experience of an overseas CGT system and was, therefore, unlikely to be influenced by the researcher, and yet had changed his CGT preference after the interview. Moreover, the interview process was considered to be consistent for all respondents. A simple check of the interviewer's pattern revealed no correlation between the percentage of time the researcher had spent in discussion with the respondents and the chance of changing their attitudes.

The information about each tax expert's choice of CGT and the level of researcher's influence (expressed as a percentage of time the researcher spent in discussion with the respondent) is summarised in Table 5.4 below.

Table 5.4 Interviewees' choice of CGT and researcher's influence

No.	Gender	Client Size	CGT (before interview)	Confidence	CGT overseas experience	Researcher's influence
1	Male	NA	Support	Strong	No	Small
2	Male	NA	Oppose	Balanced	No	Large
3	Male	NA	Oppose	Strong	No	Small
4	Male	NA	Support	Balanced-Change mind	No	Large
5	Male	Large	Support	Strong	No	Small
6	Male	NA	Oppose	Balanced	Yes	Moderate
7	Female	NA	Support	Balanced	No	Large
8	Male	NA	Neutral	Balanced	No	Moderate
9	Male	NA	Support	Strong	No	Very small
10	Male	NA	Oppose	Balanced	No	Very small
11	Male	NA	Oppose	Strong	No	Very small
12	Male	NA	Oppose	Strong	No	Very small
13	Female	NA	Oppose	Strong	No	Small
14	Male	Small	Oppose	Strong	No	Small
15	Male	Small	Oppose	Strong	No	Moderate
16	Male	Small	Oppose	Strong	No	Large
17	Male	Small	Oppose	Balanced	No	Small
18	Male	Large	Oppose	Balanced	Yes	Very small
19	Male	Small	Oppose	Balanced	No	Small
20	Male	Large	Support	Balanced-Change mind	Yes	Small
21	Male	Small	Oppose	Balanced	No	Moderate
22	Male	Large	Oppose	Strong	No	Very small
23	Male	Small	Oppose	Balanced	No	Moderate
24	Male	Medium	Support	Balanced-Change	No	Moderate

No.	Gender	Client Size	CGT (before interview)	Confidence	CGT overseas experience	Researcher's influence
				mind		
25	Female	Small	Oppose	Strong	No	Large
26	Male	Large	Support	Balanced-Change mind	No	Very small
27	Male	Medium	Support	Strong	Yes	Very small
28	Male	Medium	Support	Strong	Yes	Small
29	Female	Large	Oppose	Strong	Yes	Very small
30	Male	Small	Oppose	Strong	No	Very small
31	Female	Small	Support	Balanced	No	Moderate
32	Female	Small	Support	Balanced	No	Large
33	Male	Medium	Support	Balanced	Yes	Large

*Full-time tax teachers were denoted "NA" under the category of client size.

It is noted that more than half of the tax experts (or 17) held a balanced view regarding the CGT adoption decision. This means that the majority of the tax experts actually accepted both favourable and unfavourable arguments (factors) in the CGT adoption decision making. Thus, identification of the "critical CGT adoption factors" from the 23 possible decision factors is vital in understanding the tax experts' CGT adoption decision.

As stated at the beginning of this section, these "critical factors" or the top five factors are: (1) high tax burden, (2) negative political implications, (3) importance of private residence, (4) equity – the evaluation factor, and (5) complex CGT computation.

5.5.2 High tax burden

One major factor that hinders the introduction of a CGT is the high tax burden in the current environment. The tax experts generally considered New Zealand's tax burden as "high". In fact, all tax experts perceived this as one of the major problems in the current tax system. Some of them even suspected that "the government was profiting from fiscal management by collecting excessive revenue" since the income tax threshold of $60,000 for the highest marginal tax rates of 39% had not been indexed for inflation and more people were falling into this tax net than were initially intended.

About two thirds of the tax experts (6 tax teachers and 18 tax practitioners) considered that the high tax burden was due to the structure of tax rates and the system of social assistance and abatements. The New Zealand tax system has three levels of marginal tax rates (i.e., 19.5%, 33% and 39%) which include taxable income from the first dollar. It also provides targeted tax relief in the form of social assistance and abatements to low income families. This system is different to overseas jurisdictions which provide small tax-free thresholds and regular indexation of threshold values for the different marginal tax rates. According to one of the interviewees, "the intention of the government is that, by taking tax off all income earners and then distributing the resources back to the low income earners through the abatements and social assistance, the government has "control" rather than letting individuals have it automatically". The problem is that the tax system together with the system of social assistance and the abatements creates a very high effective marginal tax rate[47] which has, in New Zealand, resulted in a high tax burden and a poverty trap.

The poverty trap is a situation where individuals are dragged into poverty due to circumstances beyond their control. One tax expert explained how the poverty trap was created by the high effective marginal tax rate:

> Now the problem is you earn an extra dollar, it gets cut back. So like, you've got persons on a low income and all their benefits in New Zealand are taxable . . . There might be a thing called Family Support, low income earner rebate, which doesn't stop, that goes

[47] An effective marginal tax rate is different to the three foresaid marginal tax rates. It is a marginal tax rate at which the individual taxpayer in an income range pays after his/her receipts of certain social assistance and rebates have been phased out.

> up to $38,000. Below that, it might be Accommodation Supplement. Now there also might be Guaranteed Minimum Family Income. If you earn an extra dollar, you pay an extra 19 cents there. Low Income Rebate- it's a rebate and it drops to about 4 cents in the dollar there. Effective Rate for Family Support, I don't know what that is but it might be another 15 cents in the dollar, or that might be another 10 cents in the dollar. You add that up, what is it? 35, 39, 49, that becomes a 58% effective rate on the next dollar of income . . . So, my effective rates are worse than someone who is earning $200,000 and pays 39%. This is a poverty trap and there's a new measure coming into effect shortly which means for a middle income family, there is little difference [between the after tax] earning of $50,000 and $80,000.

Another tax expert considered the problem of high tax burden by referring the tax base of income tax and GST. The comment was:

> GST has actually achieved say 40% of a flat tax system now, and that is especially true when you look at an ordinary wage earner who is taxed at the 19.5 cents in the dollar, and then every penny he earns is spent, so he is paying all his take home pay on most of that apart from say the bank fees and the mortgage payment, so you could argue it is the 19.5% plus 12.5% so he is already paying 32 cents in the dollar tax. That's a very simplistic way of looking at it

The problem of high tax burden was further compounded by the taxes on daily necessities. One tax expert said:

> After your personal income tax, you pay GST and most people seem to be not saving; therefore, they are paying every disposable dollar, 1/9th of it is going in tax so you have got to add that back on. Then, if we happen to drive a car, we're paying something like, do you know what's the tax on fuel, I know my garage clients say that they only get 6 cents a litre. I think it is about 60% of the cost

> of fuel as an indirect tax. Then if you happen to smoke cigarettes hey, you've got another 50%. If you happen to drink, you've not only got GST on all of these; you also have got other taxes.

The OECD report (2007) found that the tax burden, as measured by tax revenue as a percentage of GDP, was "relatively low in New Zealand compared to most Western European countries". However, it was higher than those in major trading countries such as Australia, Canada, Japan and the United States. Most importantly, it showed an increasing trend as tax revenues rose from 34.4% of GDP in 2000, 35.6% in 2004 and 36.6% in 2006. It was suggested that such increases were due to: 1) economic growth – which boosted both firms' profitability and household incomes, and 2) bracket creep (or fiscal drag) – whereby taxpayers were pushed into higher brackets as their nominal incomes increased (OECD, 2007, p.109 – 110).

The high tax burden in New Zealand is, therefore, an impediment to pursuing a new tax. The majority of the tax experts believed that the introduction of a CGT would further increase the tax burden, which resulted in the increase of the dead weight loss to the economy. One tax practitioner stated: "The higher the [CGT] tax rates, the higher the market will cost. It is quite absurd, if you look at the IRD report to the government post election briefing, some of the margin tax rates are over 100% at the moment".

5.5.3 Social and political factors

The importance of private residence and the CGT's negative political implications are two critical influences on the tax expert's CGT adoption decision process. The strong opposition against a CGT is often due to the perceived taxation of capital gains on a principal residence. It is noted that the exemption for the private home was the most cited subject in the interview which can be explained by the social and political factors.

Social factor – importance of private residence

Most tax experts recognised that the residential property market was a vital part of the New Zealand economy, and that home ownership for individuals and society as a whole was regarded as superior to other forms of housing and investments, signalling important social values. In their opinion, the ownership of private residence was regarded as “sacrosanct”. Moreover, real estate property in New Zealand used to represent the most secure and profitable investment compared to other alternatives such as term deposit and listed company shares. At the time of these interviews, the Kiwi Saver scheme was still under public consultation. For many retirees, a paid-off home represented their entire life’s savings and could mean a comfortable retirement. Moreover, most New Zealanders have a do-it-yourself attitude and prefer improving their home for life style benefits. Added to this, external entities such as banks and financial companies also fuel the demand for the property market. As such, a CGT on a private residence was regarded by the respondents as counterproductive and hindering wealth accumulation.

Political factor – negative political implications

All tax experts acknowledged that CGT had negative political implications and the topic was avoided by most politicians in New Zealand. They often referred to what the former Finance Minister Michael Cullen’s description of a CGT as “political suicide” (New Zealand Press Association, 2000, p. 1). The general view was that any political party introducing a CGT would lose the subsequent election. Most of the tax experts considered that a CGT would be “a vote killer” for any political party. Due to its damaging political effect, the tax experts simply gave up, or did not even began, considering the design features of a CGT.

5.5.4 Equity – Evaluation Factor

Equity evaluation is another critical factor in the decision making. The tax experts often cited “equity” as the most important tax principle from amongst the three fundamental tax concepts, i.e., equity, efficiency and simplicity. However, their interpretation of “equity” sometimes differed from the one adopted in tax research. They provided many versions of “equity” in the interviews. For example, from the practitioners' perspective, "fairness" often means "reward for risk-taking". They considered a "fair" tax system as the one that did not penalise those who earned more. This was interpretation ran contrary to the traditional tax principle of horizontal equity and vertical equity.

For example, one tax practitioner argued that a CGT was "unfair" and would discourage risk taking.

> For people that are prepared to take charge of their lives and invest money, tax free capital gains are a reward for their courage. To take that away with a CGT lowers the risk/reward equation for investors. It looks like a case of those that became wealthy from tax free capital gains closing the opportunity for others coming after them.

On the other hand, some tax experts commented that the current tax system was "unfair" as it created a distortion between labour income and capital income due to the lack of a comprehensive CGT. This concept was more aligned with the traditional horizontal equity principle. As discussed earlier in 5.5.2, low and middle income earners would be adversely affected by the poverty trap due to the high tax burden and the effective marginal tax rate. In contrast, high income earners were likely to have more control over the flow of their income and had more opportunities to plan financial affairs for the avoidance of taxes. One way to achieve this outcome is by way of "negative gearing" – converting all gains to a tax free capital account with all expenditure deductible on a revenue account (as discussed in section 5.4.2). With the introduction of a comprehensive CGT, it is believed that the tax could eliminate the distortion.

It is noted that all tax experts generally agreed that "it is quite easy to change income to capital or vice versa". One tax teacher agreed with the income conversion problem and commented that:

> I see a lot of avoidance, of people just not distinguishing between capital and revenue, so I would prefer there was no distinction. I think it is artificial. Income whether it is a profit from somebody selling some shares or it's a profit from selling an investment

> property, is income, just the same as somebody earning a salary or business profits. They are all income.

The factor of “equity” was fundamental to most CGT proponents. This was also supported by the literature. However, it is observed that there were many different versions of “equity”. For example, equity was perceived by the tax practitioners as encouragement for risk-taking or a level-playing field in a tax environment. The concept was very subjective. Some tax experts might consider that justice and equity were the reasons for introducing a comprehensive CGT, while others might oppose the tax because they considered it to be inequitable. All this explains why the use of the same factor may often lead to a different decision.

5.5.5 Complex CGT computation

Another major factor considered by the tax experts in the CGT adoption decision is the complexity of the computation of CGT. The experts opposed CGT because of its complexity and considered the tax would generate more problems than it solved.

Some tax experts discussed the compliance cost and the impact on the capital market after the introduction of CGT. A tax practitioner stated:

> CGT will make doing business a nightmare as it is in Australia. Simple transactions become complicated. Tax will become more cunning and structures will be devised to avoid it. Capital investment will slow down as it will not be worth it.

Another respondent thought: “CGT should not be introduced. They complicate so many transactions by their unintended consequences as to make accountants and lawyers richer and taxpayers become poorer and far less liquid”.

All in all, one respondent gave a fair comment about the complexity problem of a CGT. He stated: “CGT would provide an opportunity to totally revamp tax and GST systems . . . political reality is that it would be a hybrid system with exemptions, making it complex and creating compliance issues”.

5.5.6 Other major factors

In addition to the top five factors, there were other important factors that were provided by the tax experts in the interviews. Other than equity, evaluation factors i.e., revenue consideration, simplicity, efficiency, and neutrality also played a significant role in the tax experts' CGT adoption decision. The majority of the tax experts often supported a simple and neutral tax system which provided a "level playing field". In most cases, the tax experts were unsure of the effects of CGT in practice. They accepted the arguments surrounding CGT (such as the capital/income boundary problem, its protection on the income tax base, and the complexity of the tax), but were concerned about the low revenue yield of CGT. In particular, they were uncertain whether the extent of the gains generated from the tax could compensate for the increased compliance cost of administering the tax. On this, one tax practitioner commented:

> While from a conceptual point of view (equity etc), CGT should be executed, personally I am against such a tax as (a) I believe individuals are overtaxed; (b) such taxes generally are very complex with increased compliance costs for taxpayers, and (c) generally do not seem to generate a large sum of revenue (in percentage terms) for governments.

In contrast, stopping property speculation was considered to be a critical factor for the introduction of a CGT. The New Zealand property market was buoyant at the time of interviews. An overwhelming majority of tax experts (26) believed that a CGT would somehow eliminate property speculation, making houses more affordable. One tax practitioner stated: "implementing CGT is ideal to curb people profiting tax free gains by way of owning numerous properties thereby forcing up prices."

5.6 Tax expert case studies

The importance of the critical factors in the CGT adoption decision is best illustrated by the following tax expert case studies. In most of the cases, it is noted that more than one decision factor was considered by the tax experts concerned during the interview.

5.6.1 Tax expert case No.1

Tax Expert No. 1 is a tax specialist in a large international accounting firm. He is an international coordinator for New Zealand, and deals with the issue of the capital/revenue distinction on a regular basis. He holds a balanced view on the introduction of a comprehensive CGT.

The survey result revealed that he indicated a level of 4, or a moderate level of agreement, for the comprehensive CGT model, and a level of 3, or neutral, for the status-quo tax system. Moreover, he was neutral (a level of 3) about the equal tax treatment of income and capital gains and preferred a preferential CGT tax rate.

In the interview, he initially recognised that the distinction between revenue and capital was difficult in borderline cases. He also considered the problem of the old FIF rules due to the efficiency factor (i.e., an evaluation factor – efficiency and neutrality). However, in terms of the overall tax system, he thought that the compliance costs were not high.

After 45 minutes, he started talking about the "headline" marginal tax rates and the tax burden. From an international perspective, he discussed the importance of the "headline" marginal tax rates (i.e. related to the "high tax burden" factor). He revealed the fact that the Chief Financial Officer (CFO) of any corporate organisation "would be sacked" if he/she did not consider the headline tax rates and their implication when making an investment decision.

Regarding CGT, he opined that the lack of a CGT in New Zealand was merely a positive factor, not a critical one in attracting foreign investments (i.e., international tax competition factor). He also did not agree that a CGT would clarify the capital/income distinction (i.e., simplicity – evaluation factor) and that there was any distortion in the investment behaviour (i.e., distortions in the investment behaviour factor). Moreover, he recognised the low revenue yield problem of a CGT (i.e., the evaluation factor – revenue consideration).

After some consideration, he favoured the introduction of a comprehensive CGT on the grounds of "equity" (i.e., the evaluation factor – equity). He stated: "What's the advantage of introducing CGT? Yes, I think it is equity." When asked to further elaborate the meaning of "equity", he said:

> My understanding of fairness is: if you made 1000 bucks and I made 1000 bucks, your wealth has gone up and so has my wealth. Regardless of what we've done, we should pay the same amount.

This was the traditional horizontal equity concept. On the other hand, he acknowledged the other version of the equity concept i.e. the risk-taking activities of business owners "should be rewarded and not penalised". There was a collision between the two different "equity" concepts. He explained:

> Yes, I can understand the concept of "if your wealth increases". I understand that in an economic sense (i.e., horizontal and vertical equity) . . . Yes, I am also very comfortable with the risk and reward concept. You take a risk, and then there's a reward there. You shouldn't be penalised by the additional effort. So in theory, I understand the horizontal and vertical equity concept, but in practice or in reality, I am more comfortable with the risk and reward definition.

When asked again if a CGT met his definition of "equity", he began to realise that a CGT might not meet the horizontal equity definition. Most importantly, he considered the critical factor – high tax burden on existing taxpayers. He stated:

> No, Capital Gains Tax will fall upon the top 5 to 10% of taxpayers, and they are already paying the most tax. . . They are making the most investment and, therefore they are taking the most risk, so why shouldn't they be rewarded? I think they are already paying the highest tax burden. . . If you exempt the family home, and $50,000 to $100,000 of investment, and you run that across your average New Zealander profile, how much, how many people are

> left to fall into the Capital Gains Tax net? . . . And this is where the horizontal equity doesn't make sense. Out of those 10,000 people, how many of those are employed in jobs above $60,000. I would say I think that correlation would be very high.

Thirty minutes later, he began to talk about another negative, critical factor – CGT additional record keeping.

> If ma and pa own their family home and have $200,000 with AMP, what's the point of bringing them into the Capital Gains Tax regime? You are now going to force somebody to file a tax return that currently isn't in the system. Maybe they've both just earned salaries and wages, and get some interest in dividends.

When finally asked if he would like to support the introduction of a CGT, he made his decision by referring to the critical factors – high tax burden and equity. He said:

> I think it (a CGT) will just end up being a tax on the wealthy. It would be a tax on the people that are already paying the most tax. Or, and I guess all companies. And so No, I don't, because I actually think those people and those companies actually drive the economy. (Interviewer): So you actually prefer the status quo? (end) Yes.

He then explained the reason for choosing the status quo by providing an example of a successful property developer. He also adopted the risk-taking equity concept instead of the horizontal equity concept and argued:

> If you've got a property developer that builds a 20 storey building and this is not capital gains, but he might make a profit he might make a couple of million dollars profit from that. But I say good on him, because in the meantime he has employed a whole lot of people, he has bought products. That's the free market argument. Yes, well that's what I believe, those people have money, they go and buy their groceries from the Warehouse and all of that, and the government needs to be doing more to encourage activity rather

> than to discourage it. So I would see Capital Gains Tax as an impediment to economic activity.

In summing up, he considered the "the importance of home ownership" "hindering saving for retirement" factors.

> Now if you take someone who is 45/50, worked hard all their life, bought three rental properties, and had $500,000 in the New Zealand sharemarket, and you told them tomorrow that they now need to pay capital gains on that when they sell, that's just . . . so de-motivating.

Several themes emerge from this case study. Firstly, tax experts generally based the CGT adoption decision on more than one critical factor. Secondly, evaluation factors such as equity, efficiency, and simplicity are very subjective. In particular, it is evident that one person can hold two different views of equity simultaneously. Thirdly, it is shown that sometimes there is only a thin line between supporting and opposing a tax system.

5.6.2 Tax expert case No.2

Tax Expert No.2 is a tax specialist in a major accounting firm. He has more than 10 years' work experience in the United Kingdom where there is a comprehensive CGT in operation. He holds a balanced-view on the introduction of a comprehensive CGT.

The survey result demonstrated that he indicated a level of 4, or a moderate level of agreement, with the comprehensive CGT model, and a level of 3, or neutral, on the status quo tax system. However, he disagreed (a level of 2) with the equal tax treatment between income and capital gains and preferred a preferential CGT tax rate.

In the interview, he initially considered that "a Capital Gains Tax would clarify a lot of the distinction between land and on the land transaction" (i.e., the simplicity factor). He also observed that there were problems with the black-hole expenditure (i.e. "non-deductibility of capital expenditure" factor). He provided the legal fees incurred in an employment personal grievance situation as an example of black-hole expenditure, and suggested that the introduction of a comprehensive CGT might help with the deductibility of such capital expenditure. As he stated:

> All you are doing is really working out whether the amount falls within being taxed under CGT or taxed under revenue; and the deductible expenses would follow according to either creating a capital loss or a deduction against revenue, so it (a CGT) might help to simplify the timing issue on the deduction.

After 45 minutes, he still considered that "a Capital Gains Tax would also get rid of some of the anomalies between land on capital account and land on revenue account". When asked whether New Zealand sufficiently taxed capital gains, he supported the factor "distortions in investment behaviour", and replied: "No, as I mentioned there are anomalies and I think you are going to tax them or you are not going to tax them. I think for the passive investor, it drives people into rental properties."

However, about 15 minutes later (at interview time of 01:00:00), he considered the problem of high effective marginal tax rate (i.e. factor "the high tax burden"). He found that the Government had removed the important tax philosophy of a "level-playing field" by increasing the tax rate to 39% (i.e., the "efficiency and neutrality" evaluation factor, and this also related to the equity evaluation factor). This move led to distortions in the tax system and in society as a whole.

He also talked about the problem with the UK's CGT on efficient and simplicity grounds (i.e., the evaluation factors "efficiency and neutrality" and "simplicity"). He knew for a fact that the administrative cost for a CGT would be high, but the revenue yield would be low (i.e., the factors "efficiency neutrality" and "revenue consideration"). He, however, noted that the biggest problem in the UK was the inheritance tax, not a CGT. He also made references to the Australian CGT and described the CGT there as "horrendously complicated".

Later, he started to confirm his decision based on the simplicity and efficiency factors. He decided to oppose a CGT, and would "exclude a lot more capital gains from the existing [system]". He gave his reason by stating: "If you think of the anomalies, the anomalies are that you have got some capital gains taxed and some are not. Well let's make them all non-taxable." He also questioned himself whether this would be a good solution. He said, "So I might create more anomalies? . . . Well, I didn't say I would solve the whole tax system. I just told you there were problems."

Ultimately, it seemed the "critical factor" was actually "equity" (i.e., the evaluation factor-equity). Near the end of the interview, he stated:

> I don't believe in a Capital Gains Tax. But if it made it fair, if that was the only way of making it fair, I would accept one. But there should be enough thresholds to fit to cover off the type of things that I have talked about, principally primary residence and thresholds so that people can get ahead a little bit, first $20,000 for the $50,000 [deposit payment]. And simple rules like any shares acquired within the first year, shares disposed of within a year are taxed as income, it is that simple threshold rule that is easy to understand . . . The other one would be, I actually don't believe in a Capital Gains Tax, then the other option is to exclude gains from the anomalies.

Unfortunately he did not further elaborate his definition of "fairness". An analysis of the interview conversation would suggest that "equity" represented exemption on private residence and small gain exemption. The tax philosophy of "level playing field", "efficiency" and "simplicity" also seemed to be vital in the determination of what was "fair". It is interesting to note this concept of "fairness" is significantly different to the one adopted in the case of Tax Expert No.1.

5.6.3 Tax expert case No.3

Tax Expert No.3 is a registered tax agent in a medium-sized accounting firm. He has full membership of the Taxation Institute of New Zealand, and has been practising in the area of New Zealand taxation for more than 10 years. He is a CGT balanced proponent.

The survey result revealed that he indicated a level of 5, or a strong level of agreement, with the comprehensive CGT model, and a level of 3, or neutral, on the status quo tax system. He also agreed (a level of 4) with the equal tax treatment of income and capital gains and preferred a preferential CGT tax rate.

In the interview, he considered the high tax burden and effective marginal tax rate as the major problems in the current tax system (i.e., high tax burden factor). He also observed that there were many taxpayers avoiding income tax by converting income into non-taxable capital gains due to the high effective tax rate. As such, he stated, "I want to remove the distinction between revenue and capital, so that income is income When it comes in you pay tax, when it goes out you claim it as an expense if you are running a business." With the introduction of a CGT, he believed that "you would have a wider base and you might not have as great a revenue falloff as you would otherwise" (i.e., the evaluation factor of revenue consideration). He also expected that this situation would result in lower income tax rates. Such a situation was similar to the one when the GST was first introduced in New Zealand.

In general, he agreed that the capital/income distinction was clear, but that there were some difficult border-line cases too. While he strongly agreed with the Haig-Simons' definition of comprehensive income in principle, he observed that there were difficulties in applying the comprehensive income concept in practice (i.e., the factor – a gap between theory and practice). Moreover, he was concerned with the fairness of the tax system (i.e., the equity evaluation factor), and favoured a "KISS" (keep it simple, stupid) approach (the simplicity evaluation factor). He explained:

> If you are looking at an individual's net worth at two points in time, then the increase is income for them. But then, I would want a whole lot of deductions from that because I want to deduct the costs of you living or surviving for that period between the two. The costs would have to be deducted because it wouldn't be fair to pay tax on that . . . And it would be very complicated to determine each of these deductions. That's another thing I believe about tax, the simpler the better, keep it simple stupid. (Interviewer): The KISS concept? (end) Absolutely, all these are to avoid these complexities.

He agreed that the lack of a CGT in New Zealand was only a minor positive factor in attracting foreign investments (i.e., international tax competition factor). However, he was not aware of the fact that New Zealand was one of the few OECD countries that did not have a comprehensive CGT (i.e., the OECD factor).

When asked whether the current tax system had covered sufficient capital gains, he considered that the tax base was not wide enough, and that for the areas where capital gains were taxed, he thought those were "probably adequate". He then reiterated the critical factors for the support of a CGT on the grounds of the philosophy of a "level playing field" (i. e., evaluation factor of efficiency and neutrality). He explained, "I like the level playing field where you have everything taxed. Why have they just chosen these areas to pay tax on capital gains? For me, you either pay tax on all capital gains, or none, really".

He then provided a further explanation on what could constitute a "level playing field" by referring to the distortions in investment (i.e., the distortion in investment behaviour factor). He stated:

> If we get back to land and rental properties . . . people invest in those rental properties because of the tax free capital gain that they will get in 10 or 20 years time when these properties are sold. Therefore, that is keeping money out of the share market perhaps. It would otherwise be invested there or in other business enterprises. So it's influencing people, because when they look at the economic

> outcome they make their decision, whereas, I like the theoretical idea that the decision is determined solely by the economic return on the investment over its life, and that taxes on all investments will be identical.

Regarding the structure of a CGT, he strongly supported the exemption for private residence and indexing for inflation (i.e., the factors – importance of private residence and inflation and indexation). Due to the exemptions and other practical problems (such as gains on land improvement, computation of liability and additional record keeping), he, however, realised that it was complex to compute the CGT (i.e., the complex CGT computation factor) because that could result in further complication of the capital/income distinction problem.

Finally, he became slightly less in favour of a CGT, even though he still supported the introduction of the tax. He admitted “I thought of it (a CGT) as a nice easy thing. Maybe it isn't in theory too easy.” He observed there was a gap between theory and practice (i.e., the factor – a gap between theory and practice). He considered that the practicality of a CGT could be an issue because “often you can have a grand theory why something will work but practically it might not be as good as it seems.”

This case demonstrated that the factors of “level playing field” (efficiency and neutrality and simplicity had played a vital role in the tax expert’s CGT decision. A similar finding is evident in the case of Tax Expert No. 2. However, Tax Expert No.3 was more optimistic than the expert in case No. 2 as he believed that the gains in efficiency and simplicity were perceived to exceed the costs of complexity. It is interesting to note that he did not believe in the concept of horizontal and vertical equity, because he considered that (i) it was a very subjective matter, and (ii) the progressive nature of the current tax system was “unfair”. This case presented a different view of fairness compared to the one adopted by both Tax Experts No. 1 and No. 2.

5.6.4 Tax expert case No.4

Tax Expert No. 4 is a tax teacher who has lectured in accounting and taxation. He also works part-time as a tax consultant for small businesses. He is a Chartered Accountant, and has been practising in the area of New Zealand taxation for more than 10 years. He is a CGT balanced opponent.

The survey result revealed that he indicated a level of 3, or neutral, on the comprehensive CGT model, and a level of 1, a strong level of disagreement, for the status quo tax system. He also agreed (a level of 4) with the equal tax treatment of income and capital gains and preferred a preferential CGT tax rate.

In the interview, he considered the overall compliance costs in New Zealand as high, particularly for small and medium sized businesses. He was also concerned with the complexity of the Fringe Benefit Tax (FBT), Controlled Foreign Companies (CFC) and the former Foreign Investment (FIF) regime.

As regards the taxation of capital gains, he recognised that there were problems with the capital/income distinction. However, he considered that income tax inherited the capital revenue problem when it first came into existence, and the problem had no solution. Theoretically, the problem could be mitigated by taxing capital gains comprehensively. He considered the "simplicity" factor:

> That's the old cat and mouse game, so by not taxing capital gains, really your income tax suffers. It gets more complex, less exceptions, more ways to try and capture things that would otherwise have fallen out of it because the differential is huge. If there was a capital gains tax, then there might not be such concern. If more things are capital gains, at least they are going to get taxed somewhere, whereas at the moment nothing.

To support his theoretical point, he also considered the "equity" and "international tax harmonisation" factors. A realisation-based CGT would be better than an accrual one. He explained:

> As far as equity goes, it (the tax system) is not equitable from the point of view of the complexity of the rules. But I suppose if you are

> caught, horizontal and vertically equity does work for you. For legislation on land sales, it is not equitable. I mean for people buying to rent or to sell, they get a loss through the tax system and they get capital gains that's not taxed and it's not equitable…
>
> …We are looking for equity and parallel with Australia. If we capture the gain, the realised gain would be a way . . . rather than capturing unrealised gains which the adjustment to the FIF regime is actually going to do. So if we are going to go for capital gains, it has to be across the board and equal. Equity has to come in.

However, he recognised the negative impacts of CGT structural factors (such as high tax burden, complex CGT computation, additional record keeping and low revenue yield). He argued that there was a collision between theoretical benefits and costs. He continued:

> From an equity point of view, it is necessary. From the compliance and overall tax burden perspectives, with the complexity of a regime of Capital Gains Tax and the cost of it, I guess the gain would be negligible. But from the equity point of view, it would be better when it is saying to people, "If you do that you will be taxed". But from [an] efficiency, or looking at the cost of dragging that extra amount of tax in, I don't think you are going to gain too much from it . . . Is it in there from an equity point of view which seems to beat the argument and if that's what you want then it doesn't matter if it's only 5% I guess, as long as your costs are actually gathering the tax up greater than what the tax is . . . Looking at if it's 5% (as a percentage of total tax revenue) in Australia, I suppose it would be difficult to associate the costs. Yes, so you feel happier about paying your tax because you feel you are being dealt with equity.

Finally, after he had considered the tax system as a whole, he opposed a CGT on the grounds of the critical factors, high tax burden, complex CGT computation and additional record keeping. He was slightly more positive about the piecemeal approach rather than a reform of the tax system by introducing a comprehensive CGT. He explained:

> No. I think we are overtaxed in New Zealand anyhow and maybe we should be seeking to reduce taxes rather than introduce new ones. If we are trying to make the system simpler and fairer then we need to re-look at [it]. We built the tax system like adding, adding, adding, rather than saying what should we have.

In fact, this tax expert's opinion represented that of the majority in the interviewees. He acknowledged the traditional concepts of equity and simplicity that had been adopted in the literature. However, the way he considered these concepts were slightly different to the way these were considered by the previous three tax experts. This variation showed the subjectivity of these evaluation criteria. Moreover, this case study revealed the importance of the "high tax burden" when considering whether a new tax should be introduced. In making the decision, the tax expert considered all relevant matters and viewed the tax system as a whole. This case again supported the observation that there was only a slight difference between the experts' CGT support and their anti-CGT sentiments in most cases. The tax might be theoretically sound, but the reality is that, in an overly taxed environment, one should be seeking to reduce taxes rather than introduce new ones.

5.7 Criteria for CGT evaluation: What makes a good tax?

In the interviews, the researcher asked the tax experts two questions i.e., (1) what were their political affiliations, and (2) what were the objectives of the tax system. The tax experts often considered themselves as "pragmatists" who were centre-right wing within the paradigm of socialist (left) and capitalist (right). They generally agreed that there was a need to provide a safety net to those who needed assistance, and that tax was raised to fund public services such as roads, education, health, and defence.

The tax experts then considered what was the most important characteristic of a "good tax" in terms of the three fundamental tax concepts, that is, equity, efficiency, and simplicity. They often cited “equity” as the most important tax principle. However, as discussed in the case studies in section 5.6, equity is a very subjective concept. In particular, there is a collision between the traditional equity concept (i.e., horizontal and vertical equity) and the risk-taking equity argument. In particular, a number of tax experts did not agree with the horizontal and vertical equity concept, and opposed the current progressive tax system. One tax expert stated that:

> I have read all the theoretical arguments about progressive tax systems which take more from those that have more. I don't actually agree with it’s philosophy. . . I don't see that it is equitable to take half a million dollars off a millionaire income earner and $500 off a $1,000 earner, that doesn't seem to be equitable to me.

Rather they supported the other version of equity concept, i.e. encouragement for risk taking. In particular, they generally favoured a flat tax system. The same tax practitioner explained:

> (Under a flat tax system), you are not penalised for working harder or more efficiently or longer hours, because you are paying the same tax percentage. But I also like if there was a mechanism for rewarding the risk, because as you say the wage and salary earner in a large and profitable firm has very little risk against that income providing they do their job, whereas a self-employed person could be doing a very good job but have quite high risk, exposed to risk of not being able to maintain that income.

Holmes (2001) stated that the meaning of equity or fairness was elusive in both a vertical equity context and in a horizontal equity context. Accordingly, there was no universally accepted agreement on the concept of equity.

Another important factor was “efficiency and neutrality”. It was observed that a number of tax experts supported the notion of a “level playing field”. A level playing field in their opinion was a broad-based single rate tax system which removed all incentives and taxed at a lower flat tax rate. Overseas experience suggested that this would result in higher growth in businesses and the economy as a whole (Littlewood, 2004). In the tax experts' opinion, a flat tax system would clearly satisfy the level playing field requirement.

In fact, they often quoted the Goods and Services Tax ("GST") as an example of "a good tax". In their opinion, GST was a flat tax system which was fair, simple and efficient, and would provide a level playing field. In addition, it was a good revenue earner. One tax practitioner stated:

> There is no good tax, but we probably have got to say fair tax . . . I think being fair, the best tax is GST. Everybody pays it. I think even taxes on fuel, if they increased the fuel tax to fund the roads, it is not good in [the] eyes of some people but good in others. Because if you say, for example, we are going to pay [an] initial 5 cents a litre on fuel to fund the Waikato expressway, people in Christchurch say why should we be paying for that because that's unfair. So, and they complain about paying for Auckland roads which I say is not good or unfair. So I think a good tax is GST and the country is making a lot of money out of it. You spend, you pay GST, it goes in the government coffers.

All the tax experts were very fond of the New Zealand GST system, which was relatively simple compared with overseas tax systems like the ones in Australia, United Kingdom and United States. In general, they considered that the core fundamentals of the tax system provided reasonable equity, some degree of efficiency, and excellent simplicity for the wage and salary earners.

In addition, emphasis was placed on the "KISS" i.e., Keep It Simple, Stupid concept. One tax teacher stated, "It should be [as] simple as possible. I mean, you may result in some inequity in the same way you do with GST. But as a tax system it is efficient and simple." The same tax expert found that "the more complex you make things in an economy the size of New Zealand, the bigger is that burden". When compared to Australia, Britain or America, the compliance costs would always be proportionally higher in New Zealand due to the small size of its economy.

In the tax experts' opinion, simplicity is particularly important because it helps taxpayers to understand the tax. One tax practitioner stated the problem with a Fringe Benefit Tax (FBT), saying "If a tax is not nice and easy and clear for people to understand, they just resent it. Now a good example is we have actually got to this point in New Zealand where a lot of people resent FBT, because it is an extra tax."

If equity is so problematic, one might consider using simplicity as the principle consideration factor. However, the reality is that no tax can be implemented without the consideration of equity. One tax practitioner observed the conflicts between equity and simplicity, and stated, "I know there is no such thing as equity, and to go for simplicity alone means that it is too blunt as an instrument."

Both CGT proponents and opponents agreed with the relative simplicity of the New Zealand tax system. However, when their results are compared, it is not surprising to find that the CGT proponents generally focused on the equity factor because of the lack of a comprehensive CGT. One CGT proponent said:

> Our income tax might be pretty good . . . You know, it's not too bad. But then if you compare it as part of the tax system, we don't have a capital gains tax so we've got these problems of these principles not being met like there's a lack of equity. If you generate resources in one way, while capital gains are treated differently compared to other taxable income, so, there is a lack of equity we talked about before. So whether you look at a tax by itself or whether you start looking at the bigger picture and look at a tax system and say the tax system is made up of a number of different taxes, how are the principles being met in that, and that's often when you see some of them are lost, whereas if you look at a tax by itself it may not be too bad.

On the other hand, the absence of a comprehensive CGT in New Zealand's tax system provides significant advantages in terms of simplicity compared to overseas jurisdictions. One CGT opponent noted the relative slimness of the Income Tax Act:

> I think it's simple compared to Australia. Sure you've got some issues with [section] CD 4, but they've got issues with having a capital gains tax. And no I think our system compared to Australia, the UK or US it's so simple. In comparison, you just have to look at how many pages it is, it's not all capital gains but some of it is. So the current system you have to say is not entirely equitable, and not necessarily efficient if you find it, but it's simple compared to in a comparative basis. The lay person in the street picking up the Income Tax Act wouldn't say it is simple but on [a] comparative basis, [it is].

It is also noted that revenue consideration was significantly influential in a tax expert's CGT adoption decision. Some tax experts suggested that a CGT could serve as a means for revenue collection by the government. However, most tax experts preferred a more "up front" approach, and considered an increase in the income tax rates or the GST rate would be a better option to raise revenue. Also given the current overtaxed environment, it is more important to reduce the tax burden and compliance of the current tax system.

In order to set the evaluation criteria for a CGT, one must carefully consider an appropriate balance between equity, simplicity, and efficiency. In the tax experts' opinion, the best tax system is the simplest ones. Transitioning to a simple tax system with fewer exemptions and incentives does not mean having to sacrifice equity and efficiency. One good example is the GST system in New Zealand. It is contrary to the general perception that a GST is not equitable due to its regressive nature. The popularity of the tax suggests otherwise; that a tax is considered to be "fair" as long as it is not punitive. Ideally the effective marginal tax rate should be neutral so that taxpayers are motivated and encouraged to engage in risk taking businesses. A flat tax system of a GST type would be able to meet this requirement. It is these reasons that make the New Zealand GST unique and more acceptable than in most countries with a similar tax system in place. Therefore, achieving maximum simplicity and neutrality with less of a punitive effect is the main evaluation criterion in the design a CGT system.

Chapter 6 Report of overall findings

6.0 Introduction

This chapter compares and summarises the results from the survey instruments and the interview data in order to provide a basis for discussion about the tax experts' overall views on a comprehensive CGT and the factors that could influence their thinking behind it. Every effort is made to answer the primary research question, i.e., "Should capital gains be taxed more comprehensively than at present?", by identifying the key policy issues and seeking the best way in taxing capital gains. This part is followed by references to the critical factors influencing their CGT adoption decision in an attempt to address the secondary research question, namely, "Why (or why not) do tax experts favour (or oppose) a comprehensive CGT?"

Section 6.1 first looks at the tax experts' own definition of "capital gains". Section 6.2 then provides an overview of the tax experts' perceptions of a CGT system by examining their feedback on each of the design features. This is followed by section 6.3 which deals with the analysis of the reasons behind the tax experts' CGT adoption decision. Section 6.4 provides a detailed analysis of the two most significant policy issues i.e., the exemption of gains on disposal of a taxpayer's main residence and the tax preference for inflation adjustment. It also discusses the future trend of taxation of capital gains. Section 6.5 then provides a review of the important policy issues about the tax expert's adoption decision, and concludes the overall findings of the comparative analysis.

6.1 What are capital gains?

Both the results from the quantitative and qualitative analyses suggested capital gains were "something that's not income". In principle, the experts considered that as long as there was a purpose or intention to sell, the taxpayer should pay tax on the profit, regardless of whether the transaction was of an income or capital nature. This view of income is a reflection of the current hybrid tax system where specific provisions are in place to tax income that would otherwise be treated as capital gains in an ordinary sense in other jurisdictions. Other types of income (such as accrual income and foreign investment income) that are inconsistent with this income concept are regarded as "specific types of income" but not viewed as capital gains.

In practice, the tax experts, particularly an overwhelming majority of the academic ones, considered that the capital/income distinction was artificial. They acknowledged that such a distinction was sometimes not clear-cut and could have other unexpected consequences in the real world. Despite the uncertainty in the capital/income distinction, the tax experts, however, considered that such a distinction had worked reasonably well in New Zealand.

Another important finding was that the Haig-Simons' comprehensive income concept, which assumes there should be no distinction between income on revenue account and income on capital account, was not well supported by the tax experts. In particular, all tax experts generally tended to oppose the accrual-based CGT, which was the purest form of the comprehensive income tax system, as they strongly agreed that the liquidity problems of such a CGT system would be significant. It is interesting to note that the majority of the tax experts supported the current hybrid income tax system, even though they agreed that the lack of a comprehensive CGT would provide more significant tax planning opportunities. If there were distortions in the tax system, they preferred a targeted approach where specific provisions could be introduced to tackle the problem. For example, both quantitative and qualitative analyses revealed that the tax experts generally supported taxing capital gains on disposal of a rental home (if the taxpayers had an intention to make a profit), while excluding gains on disposal of a main residence, personal-use property, and collectables.

Similar lack of support of the comprehensive income concept was evident in the comparative analysis of the CGT proponents' and the opponents' results. Although the CGT proponents generally perceived the comprehensive income concept more positively than did the opponents, some of the former group considered such an income concept to be flawed. In the survey, only a slight majority of the CGT proponents (56.6%) agreed that capital gain should be taxed at the ordinary tax rates. They were neutral/uncertain (median 3 and mean 2.7) about the equal tax treatment between income and capital gains, and expressed concern about the liquidity problem of an accrual based CGT (median 5 and mean 4.46). Moreover, in the interview, some of them opposed the net-wealth approach[48] in measuring a taxpayer's ability to pay, as such an approach was considered to be unfair.

Furthermore, it was observed that there was a conflict between the comprehensive income theory and the optimal tax theory, as the former income concept, which focused on the objectivity and measurability of a tax, clashed with the optimal tax theorists' emphasis on an ideal tax structure. This clash often blurred the aforementioned capital/income distinction and further complicated the incompatibility relationship between the definitions of tax law income and comprehensive income.

6.2 Perceptions of a CGT system

In this section, a review is made of numerous CGT design issues in respect of the implementation of a CGT. It summarises key findings of the comparative analyses in four major categories: 1) asset coverage, 2) computation of CGT liabilities, 3) CGT preferences and 4) accrual-based CGT. The results, with highlighted identical responses, are shown in Table 6.1 below.

Table 6.1 CGT system in quantitative and qualitative analyses

	Quantitative	**Qualitative**
1. Asset coverage		
Private residence	**Exempt**	**Exempt**
Rental property	Taxable	Taxable – but only for developers/dealers/intention for resale
Land improvement	Taxable	Taxable – but only for developers/dealers/intention

[48] A pure comprehensive income system would include all gains accruing on the disposition of financial and real property, regardless of whether such gains are income or capital, active or passive. It follows that comprehensive income is the sum of the change in an individual's net wealth plus the expenditure on consumption over the tax years.

	Quantitative	Qualitative
		for resale
Second home	Neutral/Uncertain	Exempt
Personal-use property	**Exempt**	**Exempt**
Shares (public listed, domestic)	Taxable	Exempt
Shares (foreign)	n/a	Neutral/Uncertain
Debt	Exempt	Neutral/Uncertain
2. Computation of CGT Liability		
Cost base	All costs	All necessary costs deductible
CGT events and rollovers	Neutral/Uncertain	n/a
Capital losses	Deductible against all income	Deductible against all income for CGT opponents, or capital gains only (for proponents and neutral tax experts)
Tax rates	Neutral/Uncertain	Lower than ordinary income tax rate
Part of income tax	Neutral/Uncertain	Separate tax
3. CGT preferences		
Indexation	**Strongly supported**	**Strongly supported**
General exemption	**Strongly supported**	**Strongly supported**
4. Accrual CGT		
Annual valuation	Neutral/Uncertain	Very difficult or not possible
Liquidity problem	**Strongly agreed**	**Strongly agreed**

6.2.1 Asset coverage

The taxation of capital gains on disposal of real estate property represents the centre of attention for the tax experts. Both quantitative and qualitative analyses confirmed that all tax experts strongly supported the exemption of gains on disposal of a main residence as they generally recognised the significance of home ownership in New Zealand. However, about half of the tax experts (or 15) in the interviews acknowledged that tax avoidance opportunities occurred when taxpayers could disguise their taxable investment as a non-taxable family home. Some tax experts, therefore, suggested that there should be a ceiling on the exemption for private residences.

In contrast, the findings for other real estate properties presented mixed results. For example, although the survey results showed that more than half of the tax experts supported the taxation of capital gains on rental properties and land improvements, the interview data revealed a slightly different picture when examined in more depth. In the interviews, a number of tax experts opposed the introduction of a comprehensive CGT on rental properties, but at the same time, they were not satisfied with the current tax legislation. Similar feedback was received in regard to land improvements. In the tax experts' opinion, the current tax legislation on land transactions, which served as an anti-avoidance measure, was complex and detailed, and had significant negative impacts on the taxpayers. In particular, the tax experts were concerned about the problems in adopting the subjective test of "intention" which was vital in determining the nature of a transaction. Some felt that there needed to be stronger enforcement and clearer definitions of what were meant by "developers", "dealers" and "purpose/intention for resale", where tax avoidance opportunities had occurred.

Regarding the taxation of a second home (e.g., beach house), the comparative analyses revealed that the tax experts had divergent views on the issue. Only a slight majority (56.4%) opposed CGT on such property in the survey and a similar trend was also evident in the interviews. As discussed in the previous section, most of the tax experts preferred the current hybrid income tax system. It therefore, follows that they supported broadening the tax base with the proviso that the additional taxation should be limited to the circumstances where there was an intention for resale, or transactions undertaken by developers/traders only. Since a second home was generally used for personal enjoyment and not for commercial purposes, some tax experts argued that capital gains on disposal of such property should not be taxable. However, other tax experts considered that there would be compliance issues in respect of the distinction between domestic transactions and commercial transactions if tax exemption were provided to second homes.

Another important finding regarding the asset coverage was that the tax experts strongly supported the exemption of personal use assets. They generally agreed that a comprehensive CGT would be complicated to administrate as taxpayers were required to keep a record of the costs of all of their assets. This record keeping would pose significant problems for taxpayers as they would not keep the records for insignificant personal-use assets most of the time. In order to reduce the taxpayers' compliance costs, the tax experts recommended the provision of a general exemption (more discussions on exemption in the section 6.2.3).

A related issue is the current tax treatment on personal property, specifically public-listed company shares. Under the current legislation, gains will be taxable if one of the three limbs applies i.e., dealers in properties, acquired for the purpose of resale or profit-making scheme. In the survey, about half of the respondents supported the taxation of public-listed company shares, while in the interviews, a majority of tax experts, particularly the CGT opponents, argued that as the current legislation had covered enough "capital gains", CGT should be avoided. When compared to their responses on taxation of real estate properties and personal-use assets, the majority of tax experts were less concerned with the taxation of these assets. This position probably reflected the minimal returns from the share market (McCaw, 1982 and McLeod, 2001a) and its relatively small size (Cameron, 2007). It is noted that some tax experts also cast doubt on the effectiveness of current tax legislation, i.e., personal properties were acquired for the purpose of disposal as section CB 4 – personal property acquired for purpose of disposal – was extremely difficult to apply in practice.

Furthermore, the results cast doubt on the effectiveness of the Controlled Foreign Company and the old Foreign Investment Fund ("FIF")[49] regimes in dealing with interest (e.g., from shares, etc) held in foreign entities. In fact, these two regimes, which were regarded as complex and confusing, were the areas which attracted least attention from the tax experts. Some tax experts believed that such regimes could serve only as anti-avoidance measures which were paralleled in foreign jurisdictions such as America and Australia.

Another area which attracted little attention from the tax experts was the tax treatment on debt instrument (or the Accrual Rules). In the interviews, a majority of tax experts (68%) supported the exemption of the gains realised on disposal of a debt asset. However, this result had to be interpreted with caution when it was compared with the qualitative finding. In the interviews, more than half of the tax experts (18) were neutral or not in a position to comment as most of their clients did not hold any such financial arrangement, or in some extreme cases, they themselves even did not understand the accrual rules. For those who had knowledge and experience of the tax, they considered that such a rule was "quite complex for the average man in the street". Despite this, they also thought that the regime was "probably effective and efficient" in practice. It is submitted that their support for the exemption of gain on disposal of a debt asset might reflect the view that such a gain is already covered by the current Accrual Rule regimes, and, therefore, exemption should be applied to avoid double taxation if a CGT were introduced.

6.2.2 Computation of CGT liability

The purpose of this section, prepared according to the procedures of computing the final CGT liability, is to present the results of the comparative analyses on the issues: (1) cost base; (2) CGT events and rollovers; (3) capital losses; and (4) CGT tax rate.

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[49] New FIF rules came into effect on 1 April 2007 that introduced two new methods of calculating FIF income i.e. the fair dividend rate of return ("FDR") method and the cost method.

(1) Cost base

In the survey, there was a strong degree of unanimity on the computation of cost base as all tax experts considered that most of the cost items were relevant for CGT purposes. However, in the interviews, although most tax experts supported that all necessary costs incurred should be deductible, they hardly talked about the computation of cost base in detail.

(2) CGT events and rollovers

Regarding the timing of CGT realisation (or events) and rollover, both quantitative and qualitative results revealed that tax experts were generally uncertain about the issues. In the survey, on average, they were neutral or uncertain on most CGT events, except on provisions of rollovers for business relocation, incorporation of a company, involuntary disposition, renewal of lease and spousal transfer. Notably, only three tax experts mentioned the application of rollovers in the interviews. These findings reflected the difficulty in dealing with these specific, technical issues which would generally require specialised expertise within the discipline of CGT.

Furthermore, it is noted that there was a marked association between the CGT adoption decision and application of the CGT events and rollovers. Significant differences in responses from CGT proponents and opponents were also evident in the comparative analyses in this area. The proponents were generally more willing to discuss the application of CGT events and tended to support a broader coverage with less rollover relief in a CGT system. In contrast, the CGT opponents had a strong negative feeling about most of the CGT events ("strongly disagree" or "disagree") in the survey, and showed a lack of interest in the CGT events in the interviews.

(3) Capital losses

The majority of tax experts generally supported the symmetric treatment of capital losses as well as capital gains. They strongly agreed that the deductibility of capital losses should not be restricted to being set against capital gains only. The losses should be regarded as a deductible expense so that it could be set against gross income. Further, any unused capital loss should be carried forward to the following years.

However, this result should be interpreted with caution. Such symmetric treatment between capital gain and capital loss may be explained by the large number of tax practitioners' and the CGT opponents' desire to minimise any CGT and at the same time, to maximise their tax loss. It is noted that the CGT proponents and neutral tax experts were generally more conservative in this regard.

(4) CGT tax rate

Lastly, the comparative analyses revealed mixed opinion results regarding the CGT tax rates and the appropriate tax structures. In the survey, a slight majority of the tax experts preferred CGT as a separate tax and not integrated into the income tax system. They also preferred CGT to be taxed at a lower tax rate than the ordinary income tax rate. However, in the interviews, a majority of the tax experts considered a CGT to be different to income tax and thought it should be taxed at a lower tax rate. It is also noted that although the CGT proponents were more inclined to choose the ordinary income tax rates, some of them seemed to advocate the lower inclusion rate of capital gains (such as a CGT discount). On the other hand, most CGT opponents tended to favour preferential tax rates that would be lower than the income tax rates.

6.2.3 CGT preferences

In both quantitative and qualitative analyses, all tax experts strongly supported the provisions of indexation allowance and the general exemption. The reasons for providing the indexation allowance were due to their concerns about the inflation problems and their negative impacts on the tax system. Moreover, they recognised that New Zealand had a history of high inflation rates and that taxing nominal gains was regarded as unfair as a major proportion of capital gains would be attributable to inflation. However, some tax experts noted that indexation would introduce complexity into the current tax system as other income was generally not adjusted for inflation. As such, they suggested the provision of indexation allowance be replaced by a CGT discount.

As for the provision of the general exemption, most tax experts agreed that since a comprehensive CGT taxed gains on all types of assets, the tax would be complicated to administrate as taxpayers were required to keep a record of the costs of all of their assets which could often include insignificant, personal-use properties. In their opinion, the benefit of a general exemption was that individual taxpayers who had made small gains would be exempted from filing tax returns for CGT purposes. This approach would reduce compliance costs. They considered this was particularly important in New Zealand because most individual taxpayers had been exempted from filing their tax returns. However, it was noted by some tax experts that setting the appropriate level of the general exemption could be a difficult task as a high level of exemption would provide an incentive for taxpayers to manipulate the tax system.

6.2.4 Accrual-based CGT

Both results confirmed that an accrual based CGT was not supported by the tax experts who generally considered that a realisation-based CGT would be better than an accrual one. In particular, they were concerned about the huge compliance costs involved in an accrual based CGT regime i.e., the annual valuation of all assets and the liquidity problems.

It is interesting to note that in the survey the tax experts generally agreed that the computation of the objective market price was feasible for certain assets such as commercial property, farms, financial instruments, residential property and shares in a listed company. They considered that taxing other assets, particularly personal-use property, intangibles, and shares in a non-listed company, should be avoided as they disagreed with the application of an objective market valuation on them. These findings contradicted the traditional assumption that objective market valuation was generally not feasible. It is, therefore, submitted that it is possible to implement an accrual-based CGT if one can overcome the liquidity problems and determine the appropriate asset coverage by excluding assets such as personal-use property, intangibles, and shares in a non-listed company.

6.3 Factors for CGT adoption

A number of factors that influenced the tax experts' CGT adoption were identified in the survey (quantitative) as well as in the interviews (qualitative). Both the quantitative and qualitative studies had slightly different emphases and approaches. The former was aimed at identifying the CGT structure and its practicality, while the latter focused on the in-depth examination of the above two issues, detailed exploration of current tax system, and identification of the factors for CGT adoption. Moreover, the quantitative approach, which emphasised more structured, closed-ended data, was more restricted in scope than was the flexible qualitative one.

6.3.1 General CGT issues

A general overview of five general CGT issues is first provided to build an initial evaluation of the CGT adoption factors and is discussed below:

Issue 1) Significant tax planning opportunities due to the absence of any CGT in New Zealand

One important finding of the comparative analyses was that all tax experts generally agreed that the absence of any CGT in New Zealand had provided significant tax planning opportunities. One example was the practice of negative gearing. In the interviews, a number of tax experts considered that such tax planning was very common in the property market. With an appropriate structure in place, negative gearing could often produce a variety of favourable tax treatments for property owners. Despite its tax planning nature, most tax experts (particularly the tax practitioners) did not regard negative gearing as a tax avoidance arrangement. Although it might seem unfair, they still thought it was not illegal as it was allowed in the tax legislation.

Issue 2) Taxing capital gains would clarify (and possibly remove) the distinction between capital gains and income, thus reducing the uncertainty in the application of the tax law

The findings of the comparative analyses presented mixed results. In the survey, the tax experts were neutral/uncertain whether taxing capital gains would in fact clarify (and possibly remove) the distinction between capital gains and income. The CGT proponents tended to be more positive in this regard, while the opponents generally disagreed with the possibility. However, the interview data revealed a different result. As mentioned in section 6.1 above, the majority of the tax experts argued that the capital/income distinction was generally clear and they considered that the tax laws had worked reasonably well in practice. Therefore, introduction of a CGT, which was regarded as complex and confusing, would in turn lead to more complicated boundary definition.

Issue 3) CGT would raise revenue for the government by protecting the income tax base

Similar mixed results were found in the comparative analyses regarding the revenue protection function of the CGT system. The quantitative analyses revealed that the tax experts were neutral about the issue whereas the qualitative analyses showed that the majority of the tax experts agreed with that function of a CGT. Although agreeing to the income tax protection function, they noted that the compliance costs of CGT would be very high and could exceed subsequent raised revenue. Also they argued that a CGT was itself a problem and might create additional significant problems. These findings were different from the 2006 OECD study, which suggested that the major reason for an introduction of a CGT was to secure income tax revenue. In the OECD countries, the benefits of a CGT were generally perceived to be higher than its costs.

Issue 4) CGT regarded as double taxation

The comparative analyses provided mixed results on this view. In the survey, the tax experts were neutral/uncertain whether CGT was double-taxing investors (although the CGT opponents were more inclined to agree that it was). In the interviews, half of the tax experts considered that similar to a GST, a CGT was another form of taxation, which was different from the income tax. Therefore, they considered it was not double-taxing the taxpayers.

Issue 5) With most New Zealand's trading countries having a CGT, implementation of a CGT here inevitable.

Both the quantitative and qualitative analyses showed mixed results. In the survey, the respondents generally disagreed that New Zealand would eventually follow the CGT approach of most trading countries. While the CGT proponents had mixed feelings about the issue, the CGT opponents generally disagreed with the captioned statement. In the interviews, the tax experts were neutral about the issue. Notably, it was found that the international taxation factor was the category least frequently cited by tax experts, and that only one third of the tax experts considered that tax harmonisation played an important role in policy setting. In fact, very few of them stated that the OECD's recommendations regarding the introduction of a CGT would have significant impacts on the development of the New Zealand tax system. Only eight tax experts argued that the absence of a CGT would give New Zealand businesses a competitive advantage over businesses in other countries, where capital gains were taxed.

Finally, the comparative results with highlighted identical ones are summarised in Table 6.2 below.

Table 6.2 Perception of CGT general issues in quantitative and qualitative analyses

CGT General Issues	Quantitative	Qualitative
1. Tax planning opportunities	**Agree**	**Agree. Tax planning opportunities exist due to the absence of a CGT. However, the tax planning activities (such as negative gearing) are considered to be legitimate as they are permitted under tax law.**
2. Clarification of income-capital distinction	Neutral	Disagree. In general, such distinction appears to work reasonably well in practice
3. Protection of income tax base	Neutral	Generally agree. But its compliance costs are expected to be very high.
4. Double taxation	Neutral	Generally disagree. CGT like the GST is another form of taxation, which is different from income tax.
5. International influences	Disagree	Neutral. Note that the international taxation factors have the least influence on tax experts decision making

6.3.2 Similarities between CGT proponents and opponents

An interesting feature of both the quantitative and qualitative analyses was that there were a large number of similarities in the responses of the proponents and the opponents. Although some variances and conflicts in perceptions of CGT were found in the general CGT issues and the asset coverage, most of the tax experts' responses were similar in terms of the computation of CGT liability, CGT preferences, and the implementation of an accrual based CGT. In general, there was little dividing their CGT support and their anti-CGT sentiments. In particular, in the interviews, the majority of them were in fact evenly-balanced CGT opponents who did not oppose a comprehensive CGT in theory but rather opposed the technical problems of CGT in practice. When considering the introduction of a CGT, they actually accepted both favourable and unfavourable arguments (factors). For example, one tax expert might perceive the lack of a comprehensive CGT in New Zealand as unfair (the equity factor), but opposed the introduction of a CGT due to the additional filing requirement that would capture the current non-filing taxpayers (the factor of "CGT additional record keeping").

Similar CGT support and anti-CGT sentiments were also evident in the survey. Some tax experts, particularly the neutral ones, disagreed with both the existing tax system and a comprehensive CGT. One possible explanation was that they might possibly be unsatisfied (i.e., a low level of support) with the status quo tax system while still casting doubt on the effectiveness of a CGT system (i.e., a low level of support to CGT system).

6.3.3 CGT adoption factors

The qualitative analyses had identified 23 major CGT adoption factors. The tax experts relied on these taxation and external factors/reasons to choose a particular CGT model, i.e., the status quo system or a more comprehensive CGT system. They often had more than one reasons to support their decision.

As an abstracted table from Chapter 5, Table 6.3 below reveals the following top 10 CGT adoption factors.

Table 6.3 Top 10 CGT adoption factors

Ranking	Factor	Category
1	High tax burden	Tax Environment
1	Negative political implications	Social and political
1	Importance of private residence	Social and political
4	Equity	Evaluation
5	Complex CGT computation	CGT Structure
6	Inflation and indexation	CGT Structure
7	Simplicity	Evaluation
8	Stopping property speculation	Social and political
9	CGT additional record keeping	CGT Structure
9	Revenue consideration	Evaluation

The top three factors, which have equal ranking and the same scores, are: high tax burden, negative political implications, and importance of private residence. The main theme of this clustering thus emerges: The decision for choosing the way in which to tax capital gains was dominated by non-CGT structural factors.

These top three factors were followed by other that influenced the tax experts' CGT adoption decision. In particular, the complexity of the computation of CGT and the four evaluation factors (i.e., equity, revenue consideration, simplicity, and efficiency /neutrality) played a significant role. In most cases, the tax experts were unsure of the effects of CGT in practice because of the complexity of its computation. They accepted the arguments surrounding CGT (such as the capital/income boundary problem, its protection of the income tax base, and the complexity of the tax), but were concerned about the low revenue yield of CGT. They were particularly uncertain whether the extent of the gains generated from the tax could compensate for the increased compliance cost of administering the tax.

Notably, stopping property speculation was considered to be a critical factor for the introduction of a CGT following the factor of equity, it was a secondary reason for adopting CGT. At the time of interviews, the New Zealand property market was buoyant. To make housing more affordable, an overwhelming majority of tax experts (or 26) believed that a CGT would somehow reduce property speculation.

6.4 Policy considerations

From the viewpoint of achieving an implementable income tax policy, an important policy consideration of a comprehensive CGT is the identification of those attributes (i.e., taxable activities, exemptions, tax relief or deductions based on individual taxpayers' circumstances) that should be included or excluded from the tax base. This identification was achieved in sections 6.1 and 6.2 which explored several important policy issues and reviewed their implication for the adoption of a CGT in New Zealand. Amongst the discussed policy issues and attributes, two most significant issues emerged from the findings, namely, (a) exemption of the gains on disposal of a taxpayer's main residence, and (b) tax relief for inflation adjustment. The purpose of this section is to investigate these issues in detail with special reference to the relevant literature and the CGT adoption factors found in the tax experts' decision making process.

6.4.1 Implication of CGT adoption factors

Striking an appropriate balance from amongst all the CGT adoption factors is important when considering the policy formulation of a CGT. In theory, the tax base of a conceptual CGT should be wide enough to represent as many types of gains as is practicable, so that the tax base would match the one in a Haig-Simons' comprehensive income tax system. However, the reality is that, as shown in this study's analyses, most tax experts did not agree on the concept of comprehensive income. In particular, some of the tax experts cast doubt on the horizontal equity principle for adopting a CGT. The findings are inline with those of Hettich (1979) who found that the horizontal equity of a comprehensive CGT was subjected to continuous criticism. In his view, “complete consistency in the treatment of all types of income was beyond reach” (p. 6). This failure would often result in adopting a narrower interpretation of income out of pragmatism as there would always be a trade-off between theoretically pure, and administratively practical, concepts in reality.

Furthermore, as discussed in Chapter 5, a tax was considered by the tax experts as “fair” as long as it was not punitive. A good example of a “fair tax” was the flat tax system of a Good and Services Tax (GST). However, this was not consistent with the concept of equity (particularly vertical equity) as GST was a regressive tax. In fact, Seligman (as cited in Holmes, 2001) argued that the ideal of justice in taxation might vary over time with the alteration in social conditions.

Above all, the tax experts considered that the best tax system would be the simplest one i.e., a tax system with the broadest tax base and fewest exemptions and incentives. Simplicity is important as New Zealand cannot afford to have a complex system due to its relatively small size. At the same time, the tax has to be levied as efficiently as possible. Compared to other OECD countries, the New Zealand tax system has been described as one of the most efficient and simplest (Leibfritz, Thornton, & Bibbee, 1997; OECD, 2000, 2007). The effectiveness of the tax collection system (as measured by the revenue collected for every New Zealand dollar spent) is also reported to be high and it ranks eighth amongst the OECD countries. Therefore, for policy consideration, it is submitted that simplicity and neutrality (or efficiency) with the aforementioned tax experts’ own notions of “fairness” i.e., not punitive, might serve as the guiding tenets in the design of a CGT system.

6.4.2 Exemption of a taxpayer’s main residence

Both the survey and the interview data revealed that most tax experts opposed taxing the principal residence. In the interviews, they considered that it was “unfair” to tax principal residence and agreed that no political party would have a CGT on a principal residence. These observations also showed the fact that overseas jurisdictions taxing capital gains generally exempt gains on disposal of the taxpayer's principal residence (subject to certain conditions). Moreover, the resistance was further increased by the strong political opposition to the taxation of gains on principal residence disposal. Such a fact is, perhaps, itself a strong argument for a tax exemption. Although the tax experts had divergent views on the meaning of fairness as a tax evaluation criterion, an overwhelming number of them had no doubt about the social injustice caused as a result of the taxation of a principal residence.

The current tax exemption on owner-occupied housing may be regarded as a periodic subsidy to home owners. Goldberg (1994) considered that if the subsidy were eliminated, the transitional effect would be significant as the after-tax cost of home ownership would increase and single-family home prices would decrease. This transition would be likely to cause considerable economic dislocation and financial hardship to current homeowners, resulting in home ownership being less desirable relative to renting.

On the other hand, the Valabh Committee (1989) argued that the non-taxable nature of housing would create a tax shelter which would encourage over-investment in brick and tile by high income earners. In particular, it proposed that changes in the real value of owner-occupied houses should be included in the income tax base. It was argued that the tax exemption on the principal residence created a tax advantage in owning a house (McLeod & Oliver, 1990). This was because a person renting a house would be paying the rent out of after-tax income while the owner of the home paid rent in the form of imputed rental income which was derived from before-tax gross income. In general, this advantage would be capitalised and passed onto the house prices. By taxing capital gains on a taxpayer's principal house, the tax system would be more neutral, and this neutrality could result in a reduction in the house's price as the tax exemption would no longer exist. Notably, the Valabh Committee was fully aware of the trivial real capital gains (i.e., true gains not including any inflationary element) in real estate over the period from 1962 to 1988, and the relatively large compliance and administrative costs for its proposals. To mitigate the administrative problems, an indexed standard annual allowance ($4,000) would be allowed to be added to the acquisition cost. Alternatively, a house owner could claim the actual amount of expenditure incurred on capital improvements when sufficient records were provided.

According to the 2007 OECD report, the overwhelming majority of assets for New Zealanders were in the form of home equity. The author in the report observed that there was a tax advantage on owner-occupied housing over other financial investments: owner-occupied housing was tax exempt while financial investments were taxed on income and capital gains (to a certain extent). Although the overall tax preference that benefitted owner-occupied housing was not large compared to that in other OECD countries, it argued that the tax advantages would create distortions of allocation of savings and divert valuable capital away from possibly more productive uses (OECD, 2007, p. 127).

The 2007 OECD report subsequently recommended a few alternatives to remove some of the distortions. Firstly, it suggested the introduction of a national tax on land as it would be more effective than a realisation-based CGT on housing due to the lock-in effects of CGT. Secondly, as an alternative measure, the report suggested that New Zealand should adopt a dual income system which limited the deductions to rental income. Lastly, it considered that an abstract version of a CGT could apply to housing investment acquired for business-purposes, that individuals, claiming for the deduction of interest, repairs and maintenance on housing investment, would be subject to a CGT, and that no CGT would be levied for those choosing not to apply for the deduction.

In contrast to taxing the disposal of principal residence, the tax experts had mixed opinion on taxing other real estate properties. In fact, many of them cast doubt on the effectiveness of the current tax regimes regarding the taxation of land and other real estate property transactions. Known to be very complex and detailed, the current tax regimes on land transactions have been the main area drawing the tax experts' centre of attention. Interestingly, the survey results showed that more than half of the tax experts supported the taxation of capital gains on rental properties and land improvements, whereas the interview results revealed that a number of tax experts were not satisfied with the regimes. The latter felt that the current tax legislation failed to serve as an effective anti avoidance measure as it was problematic to apply the subjective test of "intention" to determine the true nature of a transaction, in practice. Some even considered that stronger enforcement and further refinement of the legislation were needed in order to prevent tax avoidance arrangements.

It is noted that a 2008 OECD discussion paper, titled "Tax and Economic Growth", suggested that taxes on residential property, particularly recurrent taxes on land and buildings, were "likely to be best for growth" due to their lesser distortive effects than other taxes (Johansson et al., 2008, p. 7). It continued that property taxes included recurrent taxes on immovable property, taxes on gifts and inheritance and taxes on financial and capital transactions and that these taxes were generally low revenue yielding property taxes in most OECD countries, except in countries such as United Kingdom, Korea, the United States and Canada where the property taxes represented at least 10% of the overall tax revenue. Despite the advantages of taxing residential property, the above paper, however, noted that only a few countries managed to raise substantial revenues from property taxes as most countries had already included property taxes at the sub-national government level (such as rates), and that governments generally had to tax property taxes more lightly than other taxes due to their unpopularity.

In short, taxing land and property transactions is very challenging from a political point of view. In particular, the question of how to tax capital gains on a taxpayer's principal residence remains unclear. Taxing owner-occupied property might have the advantage of increasing efficiency in revenue collection, but most countries generally offer tax preferences or exemptions for owner-occupiers. Such tax advantages are often motivated by social objectives i.e., to assist low income earners in acquiring a home. This perspective, as reflected by the tax experts, is especially true in the New Zealand situation. As noted by one tax expert, "no matter what the tax committees and the OECD's recommendations on the taxation of housing, the Government will quickly oppose the proposal and announce that family homes will never be taxed".

6.4.3 Tax relief for inflation adjustment

One critical CGT adoption factor, a major problem with the current tax system as perceived by all tax experts, was the high tax burden in the current environment. A majority of the tax experts considered that this problem was caused by the tax rates structure and the social assistance and abatements system, which all together produced a very high effective marginal tax rate. The overall outcome was that the general public suffered from the poverty trap as taxpayers were dragged into the poverty net due to this high tax burden.

Inflation effects were presented as one of the tax experts' major concerns in the interviews. Some tax experts felt that the current tax regimes were unfair as taxpayers were unwillingly shifted into higher tax brackets when their nominal incomes increased. However, the increase was mainly caused by inflation while real incomes in fact might not have increased. They considered that the government should only tax real gains, especially during the taxpayers' holding period with substantial high inflation.

The Valabh Committee (1989) considered that inflation would increase the effective tax rate on income taxed on realisation as there was no relief for inflationary income. Under the current realisation-based tax system, it was argued that the benefit of holding tax-free income until realisation should outweigh the impacts of inflation over time. Since both inflationary and real income were taxed for certain types of assets (such as land), the effect of inflation was inversely proportional to the holding period, and this had a significant impact on the effective rate of taxes on income from different types of assets (Commerce Clearing House, 1990). In particular, financial arrangements and trading stock would be the areas most affected due to the accrual tax treatment on these assets. The Committee also found that the effects of inflation would be less severe where assets were held for a period until disposal i.e., deferral of tax results in lower effective tax rates, thus reducing the inflationary effect.

The McLeod Committee (2001) provided an example to demonstrate the impacts of inflation on effective tax rates as shown in the following case example:

Helen purchases an interest-bearing bond of $100 that matures in a year's time for $107.12, including annual interest component payable at maturity. The bond's before tax annual yield is, therefore, 7.12%.

Inflation during the course of the year is 3%. The tax rate is 33% levied on taxable income measured in a way that does not take account of the effect of inflation in eroding real income.

Helen's income before adjusting for inflation is $7.12, and tax payment is $2.3496 (i.e., 7.12 x 33%)

Helen's real inflation adjusted income is $4 (i.e. (1.0712/1.03 – 1) x 100).

Helen's taxable income, therefore, equates to 178 percent of her 'economic', or true income (i.e., 7.12/4), and the effective tax rate on Helen's interest income is 58.74% (i.e., 2.3496/4). As a consequence, the tax system taxes more than 100 percent of real income.

Source: Tax Review 2001- Issues Paper, McLeod Committee (2001) Example 1.4: Effective Tax Rates on Real Income, p. 12

Most OECD countries do not attempt to adjust the effects of inflation due partly to the complexity of doing so and partly to the belief that inflationary gains are no longer as prevalent as they once were (OECD, 2006b). Despite this, some researchers supported indexing capital gains as the indexation allowance was more equitable than the CGT discounts (Freebairn, 2001; Bracewell-Milnes, 2001). These researchers suggested that the practical compliance and administrative costs of the indexation allowance in Australia and the United Kingdom were in fact trivial. In their opinion, the computation of the allowance was very simple as it involved the straight forward application of the available quarterly values of the consumer price index provided by the tax authorities.

The Valabh Committee (1989) made a comment on designing an indexation system. It considered that the system would apply not only to capital gains, but also to other form of ordinary income from capital such as interest income (other than wages and salaries and income from personal services). The most appropriate index would be the Consumer Price Index.

The cost base and any subsequent capital expenditure should be adjusted for the effects of inflation. There were three different options for such an adjustment. A taxpayer could:

1. Defer the calculation of the indexed cost base until the realisation of the gain (at the time of disposal);
2. Calculate the indexed cost base on an annual basis; or
3. Calculate the indexed cost base every indexation period.

The above Committee also discussed the merits of each option. Option one would be more appropriate for taxpayers who purchased non depreciable assets with an intention of retaining them for a comparatively long period and not making frequent capital improvements. Option two and three would suit those taxpayers who purchased and/or disposed of part of the asset through an indexation period(s).

As for capital loss, provided that the tax avoidance opportunities could be minimised, all taxpayers should be able to claim a deduction for real losses attributable to an excess of the indexed cost over consideration received upon disposal. The Valabh Committee's opinion on this issue was that it was less restrictive than the previous Australian indexation system (abolished in 1999[50]) where only nominal loss was allowed for deduction (i.e., consideration < unindexed cost), and that no deduction of capital loss was allowed if there was a nominal gain even though there might be a real loss incurred (i.e., consideration < indexed cost base). Regarding anti avoidance measures, the Committee recommended that capital losses would need to be ring-fenced so that losses on

[50] While indexation of the cost base was frozen at 30 September 1999, the removal of indexation applied to expenditure incurred after 11.45 am on that day.

the disposal of any form of property could be deductible only against gains from the disposal of property.

All in all, most tax experts considered that a full indexation system would have substantial benefits in terms of equity and efficiency in the tax system. In their opinions, an indexation would significantly reduce the tax burden on individual taxpayers.

6.4.4 Future trend

The future of a comprehensive CGT is unclear. The main reasons for taxing capital gains are largely motivated by the notions of equity and dampening effects on property speculation in the housing market. While nearly all tax experts recognised the significant tax planning opportunities due to the absence of any CGT, they were uncertain the introduction of a comprehensive CGT would solve the problem. In theory, if capital gains were taxed as income, this would avoid the problems of distinguishing between income and capital receipts and reduce the erosion of the tax base. However, the overall results found that most tax experts opposed the comprehensive income concept.

On the other hand, the support for lower tax rates on capital gains was evident in both the survey and the interview results. The majority of the tax experts generally considered that capital gains were not regarded as “ordinary income” and the gains should be taxed at a lower tax rate. The findings were parallelled with the global tax development. Over the last 50 years, many OECD countries have moved away from the comprehensive income approach to dual income or “semi-dual” income tax systems, making some forms of capital income subject to tax at a lower or flat rate and other forms of income at higher and progressive rate(s) (OECD, 2006b). Table 6.4 below compares the top marginal tax rate (or the flat rate if applicable) on labour income and capital gains (both short-term and long-term) derived from the sale of shares in the 2005-06 income year. It also shows that no existing system taxes all types of income in an equal manner as mandated by the Haig-Simons’ comprehensive income concept. In general, the OECD average for the top marginal tax rate on labour income (48.9%) is higher than the one on capital gains. The OECD average for the short-term holding period is 15.2%, while the corresponding figure for the long-term holding period is 14%. This suggests that preferential tax treatment is given to capital gains on shares held for a longer term (for 10 years and more) before disposal.

Table 6.4 Top marginal effective tax rate on labour income[a] and capital gains on shares (2005/06)

Countries	Labour income[a]	Short-term capital gain on shares[b]	Long-term capital gain on shares[c]
Australia	46.7	24.3	24.3
Austria	41.9	0	0
Belgium	68.4	0	0
Canada	36.6	23.2	23.2
Czech Republic	55.9	0	0
Denmark	63	62.9	43
Finland	58.9	29	29
France	59.6	27	27
Germany	44.3	0	0
Greece	60.6	0	0
Hungary	62.8	20	20
Iceland	38.8	10	10
Ireland	49.9	20	20
Italy	58.8	12.5	12.5
Japan	32.6	10	10
Korea	23.6	20	20
Luxembourg	54	0	0
Mexico	29.8	0	0

Countries	Labour income[(a)]	Short-term capital gain on shares[(b)]	Long-term capital gain on shares[(c)]
Netherlands	52	25	25
New Zealand	39	0	0
Norway	51.3	28	28
Poland	53.4	19	19
Portugal	55.6	0	0
Slovak Republic	42.8	19	19
Spain	37	15	15
Sweden	67.2	30	30
Switzerland	42.8	0	0
Turkey	49.4	0	0
United Kingdom	47.7	40	24
United States	43.3	20.3	20.3
Average	**48.9**	**15.2**	**14**

a) Includes income tax plus employee and employer contributions less cash benefits

b) Capital gains on shares held for more than 1 year but less than 2 years

c) Capital gains on shares that have been held for 10 years before sale.

Source: Adapted from OECD (2006c) Table I.6 and Australian Government (2006) Table 6.2.

The results should be treated with caution as they present the CGT treatment on shares only and not on other properties such as land. Moreover, they do not represent the effective CGT tax rates. For example, some countries such as Austria, Belgium, Czech Republic, Germany, Greece, Luxembourg, Mexico, Portugal, Switzerland and Turkey follow a targeted approach which taxes specific capital gains (although they do not tax capital gains on public corporate shares in general). For these countries, the targeted types of capital gains are generally treated either as business income or "speculative gains" in the nature of business income (OECD, 2006b). When making a comparison, it will be necessary to consider the impacts on other taxes such as federal and provincial taxes, as these would undoubtedly add another layer of complexity due to differences in tax rates at the local and regional levels.

For policy considerations, there are advantages and disadvantages for providing a preferential CGT tax rate and moving away from the pure comprehensive income approach to either a targeted CGT system or a semi-dual system. The problem with such a system is that it will encourage entrepreneurs to avoid a higher income tax by converting labour income to capital income. Also the different treatment of ordinary income and capital gains gives rise to equity concerns. Nevertheless, the 2006 OECD report (OECD, 2006b) presented several advantages of such an approach. Firstly, it reduced the disincentive to save as capital gains would be taxed at a lower rate. Secondly, a lower tax rate could offset the tax burden as a CGT tended to be applied at the nominal rather than the real return on savings. Thirdly, it mitigated the tax avoidance problem as capital owners were less motivated to move their savings offshore in an attempt to avoid tax. Finally, lowering the CGT tax rate could reduce the lock-in effects (where taxpayers tend to defer realisations under a realisation-based CGT system) and thus increase tax revenues. For example, in Ireland a significant increase in tax yield was noted following the reduction in 1998 of the CGT tax rate from 40 to 20% and reduction in lock-in incentives as the decrease in the tax rate had contributed to an increase in CGT tax revenues from 245 million euros in 1998, to 1,436 million euros in 2003 (OECD, 2006b, p.11).

6.4.5 Conclusion

Some pieces of interesting information were found in the comparative analyses. One important finding was that the Haig-Simons' comprehensive income concept – which assumed there should be no distinction between income and capital gains – was not well-supported by the tax experts. In particular, most tax experts considered that a pure, comprehensive income system, i.e., an accrual-based CGT, was not feasible in practice as they were concerned about the liquidity problems and the compliance costs involved in an accrual based CGT regime i.e., the annual valuation of all assets.

A possible explanation for the unpopularity of the Haig-Simons' comprehensive income concept was that many tax experts considered it was unfair to tax comprehensive capital gains. In fact, they disagreed with the benefits derived from the gains in horizontal equity through adopting a CGT. They regarded a tax to be "fair" as long as it was not punitive. A good example of a "fair tax" was the flat tax system of the Goods and Services Tax (GST). This finding is ironic as most literature suggests that a GST is inconsistent with the concept of equity, (particularly vertical equity) due to its regressivity. In fact, the tax experts actually preferred the simplest tax system with the broadest tax base and fewest exemption and incentives. While equity still plays an important role in policy setting, simplicity and neutrality (or efficiency) might serve as the main criteria in the design of a CGT system.

Amongst the policy issues and attributes discussed in the comparative analyses, two most significant ones were 1) exemption of the gains on disposal of a taxpayer's main residence, and 2) tax relief for inflation adjustment. All tax experts strongly supported the exemption of gains on disposal of a taxpayer's main residence as they generally recognised the significance of home ownership in New Zealand. Previous tax committees and literature have suggested the advantages and disadvantages to provide such exemptions. It is a very challenging task from a political point of view to implement the measures in practice.

In contrast, inconsistent results were found regarding the taxation of other real estate properties. The survey results showed that more than half of the tax experts supported the taxation of capital gains on rental properties and land improvements, whereas the interview data revealed a slightly different picture. These findings showed that while some tax experts opposed the introduction of a comprehensive CGT on rental properties and land improvements, they might, at the same time, be not satisfied with the current tax legislation, particularly the one on land transactions.

All tax experts strongly supported the provision of tax relief for inflation adjustment as they were concerned with the negative impact of inflation on the tax system. Many of them believed that the general public suffered from the "poverty trap" due to the inflationary effect that dragged taxpayers into higher tax brackets as a result of the taxation of the nominal income instead of the real income. In their opinions, an indexation would significantly reduce the tax burden on individual taxpayers. Despite this, most OECD countries nowadays do not attempt to adjust the effects of inflation due partly to the complexity of doing so and partly to the belief that inflationary gains are no longer as prevalent as they once were.

It is perhaps interesting to note that a standout feature of the comparative analyses was that there were a large number of similarities in the responses of the proponents and the opponents. Apart from some variances and conflicts in certain specific areas (such as the general CGT issues and the asset coverage), most of the tax experts' responses were similar in terms of the computation of CGT liability, CGT preferences, and the implementation of an accrual-based CGT. In general, it was considered not easy to exactly separate their positive CGT statements from their anti-CGT sentiments. In most cases, they accepted the arguments surrounding CGT (such as the capital/income boundary problem, its protection of the income tax base, and the complexity of the tax), but were concerned about the low revenue yield of CGT. They were also uncertain of the effects of CGT in practice.

Chapter 7 Summary and conclusion

7.0 Background to the study and research objectives

Over the last 20 years, tax scholars and many government tax committees have attempted to address the question of whether to expand the tax base to include more capital gains or to adopt a comprehensive CGT. However, the result has been mixed and uncertain. While a CGT system is generally considered to be complex and more complicated to administer than other taxes, the experience of other OECD countries suggests that a CGT provides the benefits of: securing tax revenues; improving efficiency; strengthening horizontal and vertical equity; encouraging savings and investment; and simplifying the tax system (OECD, 2006b).

It has been argued by some researchers that New Zealand has no CGT. At a purely theoretical level, this may be the case. However, the reality is that certain capital gains are collected as taxable income under the Income Tax Act 2007. Over the years, there is evidence that the New Zealand Government brought more "capital gains" into the tax net by widening the tax base through the introduction of specific legislation. At a practical level, such partial inclusion of capital gains (or hybrid approach) by no means constitutes a comprehensive CGT. The end result is that this system leads to inconsistent system and complications which blur the capital/income distinction. Therefore, it is suggested that the current tax system is in need of a review, particularly regarding the issues surrounding the capital/income distinction and the extent to which capital gains are taxed, and that the issue of introducing a comprehensive CGT should be considered in a wider part of a general review of taxation.

The objective of this study was to explore the key issues, aspects and attributes concerning CGT in New Zealand. In this respect, efforts were made to look at a number of design issues in respect of the implementation of a CGT from a policy perspective. This study has addressed the primary question of whether capital gains should be taxed more comprehensively than at present. It has also identified several important policy issues and reviewed their implication for the adoption of a CGT in New Zealand.

This study has also answered the secondary research question, i.e., why (or why not) do the tax experts favour (or oppose) a comprehensive CGT. In this respect, the study examined the issues surrounding the cases for and against taxing comprehensive capital gains in New Zealand and posed 23 factors/issues that were related to tax experts' attitudes towards particular form of a CGT model (i.e., current hybrid approach, a realisation-based CGT or an accrual-based CGT). These included the taxation factors (such as current tax rate structure, tax burden) and non taxation factors (such as social and political factors). Finally, the study had identified the characteristics of "a good tax" practice from the tax experts' perspectives.

Initially, the survey result suggested insufficient support for moving toward a comprehensive income tax base and the taxation of capital gains. However, a comparison of the CGT proponents and opponents positions showed mixed results: Taxing income in a comprehensive manner was not necessarily less accepted, as the quantitative data suggested. Although the tax experts' views on having a CGT, or not having one, were often polarized, there were also significant similarities in individual responses. In particular, the decision for choosing the way to tax capital gains was significantly affected by non CGT structural factors such as the high tax burden in the current tax environment, and social and political factors. In the interview phase, the majority of the tax experts were balanced CGT opponents who did not oppose a comprehensive CGT in theory but rather opposed the technical problems of a CGT in practice. They accepted both favourable and unfavourable arguments (factors) in their CGT adoption decision making. In some cases, there was only a marginal distinction between their CGT support and their anti-CGT sentiments. The identification of the "critical CGT adoption decision factors" is vital in understanding the tax experts' CGT adoption decision.

7.1 Research methodology and method

A mixed methods design was adopted in this study. This research strategy, which involved both a qualitative and a quantitative approach, was used to determine the extent of the tax experts' perceptions of a CGT in New Zealand and to capture a more complete understanding of the constructs of a CGT model and the CGT adoption factors.

The first phase of the research involved conducting a questionnaire survey. The questions in the survey were mostly close-ended (QUAN), with a space provided for written feedback (QUAL). Data were first collected from a small group of tax experts, i.e., New Zealand tax teachers. After collecting most of the completed questionnaires from the respondents, the researcher revised again the survey instrument for use exclusively with the larger group of tax experts, i.e., tax practitioners throughout New Zealand.

Data were then aggregated to form a single base of tax experts for compiling a statistical analysis. The tax experts' overall perception of a CGT model was found by summarising all the responses to the survey instruments. This process included a review of the tax experts' views on seven major areas: 1) general CGT issues, 2) asset coverage, 3) computation of cost base, 4) CGT events, 5) CGT preferences, 6) issues about the integration with current tax legislation and 7) accrual based CGT.

In addition, two major groups of tax experts were identified, namely, the CGT proponents and the CGT opponents. This grouping was used to examine factors that affect tax experts' attitudes to a CGT model by comparing their opinions.

Phase Two of the research involved interviewing the tax experts. An individual, face-to-face, semi-structured and open-ended interview was chosen for the study. Respondents to the main survey were invited to participate in the follow-up interviews. While the follow-up interview played an important role in data collection from the tax experts, the interview data was seen as providing an in-depth understanding of their experience as described in a first person account, thus enabling the researcher to undertake a comprehensive review of the tax system. This approach also enabled the researcher to gain a deeper understanding from the viewpoint of the actual participants.

For the qualitative analysis, coding was used to identify the phenomena and to establish a taxonomy of factors that influenced the tax experts in the decision making process. All data sources were triangulated using the NVivo software.

Finally, Phase Three of the research compared the results in Phase Two with those in the First Phase. The final results provided a basis for discussion about the tax experts' overall views on a comprehensive CGT and the factors which influenced their decision making process in the CGT adoption decision.

7.2 Research findings and contributions to knowledge

A review of the extant literature and research about the taxation of capital gains in Chapter 2 identifies the limitations in current knowledge, due to the elusive concept of capital/income distinction, the external influences in international taxation, and the inequity of the current tax system. Other weaknesses in current knowledge involve suitable conceptual framework to explore the issues surrounding the cases for and against taxing comprehensive capital gains in New Zealand. This research has, to a certain extent, offered a contribution to the body of knowledge. Consequently, it aims to provide an overview of current thinking for policy making as it has discussed the issue of taxing comprehensive capital gains in the wider context.

7.2.1 Phase One: quantitative findings

In Phase One, this study survey explored the key issues concerning the taxation of capital gains in order to build a preliminary theoretical framework. Generally, the results confirmed that the majority of the tax experts supported the current hybrid income tax system rather than a comprehensive CGT, even though many of them agreed that the lack of such a tax could result in more tax planning opportunities. The following are the essential features of the tax experts' perception of a CGT model in Phase One:

- exempting gains on disposal of main residence and personal-use property,
- applying residence-source rules to overseas assets held by New Zealand residents and to assets in New Zealand owned by foreign non resident taxpayers,

- deduction of most of the cost items, such as: 1) agent fees, 2) debts to finance the property, 3) improvement expenditure for property, 4) interest for financing the property, 5) legal fees and stamp duty, 6) market value of any property a taxpayer gave or is required to give in respect of acquiring a CGT asset, and 7) purchase price,
- "deemed disposal" regime for taxpayers who cease to be tax residents in New Zealand,
- provision of tax preferences such as adjustment for inflation and general exemption for small gains, and
- applying deduction of capital loss not only to capital gain, but also to ordinary income with any unused capital losses being carried forward to the following years.

It is interesting to note that nearly half of the CGT opponents supported taxing capital gain on disposal of a rental home. Perhaps more predictably, CGT proponents overwhelming supported the application of CGT on disposal of a rental home. However, a closer analysis of the results with the supplementary information provided by the tax experts revealed the fact that they preferred the current hybrid income tax system where capital receipts on disposal of a rental property is taxable as ordinary income if the taxpayer had a profit-making intention. In other words, the tax experts would have opposed a CGT if there is no profit making intention by the taxpayer.

It is also noted that most tax experts considered it was difficult, but not impossible, to apply an accrual-based CGT in practice. The results suggested that obtaining the market value of certain CGT assets (such as commercial property, farms, financial instruments, residential property, and shares in a listed company) was feasible and the difficulty of doing so might have been overstated. However, it was recognised that liquidity problems would exist if an accrual-based CGT were adopted.

7.2.2 Phase Two: qualitative findings

In Phase Two, interviewing was used to provide an in-depth understanding of the phenomena of capital gains taxation. One significant finding was that there was no widespread agreement on the fundamental principles of capital gains taxation. Tax experts presented very different views on the taxation of capital gains. The key views being:

- there were various theoretical definitions of income and capital gains,
- capital/income distinction was elusive and there was a lack of support from the Inland Revenue to clarify such a distinction, and
- the area involved complex tax legislation, particularly for the legislation concerning the taxation on land transactions, the international taxation, and the Accrual Rules.

According to the tax experts' perceptions of a comprehensive CGT, a CGT was generally regarded as "a tax on the profits from the sale of assets". Interestingly, some tax experts stressed the similarities between a CGT and the Fringe Benefit Tax (FBT) – both taxes contributing to improving equity at the cost of increasing compliance for taxpayers. When considering the tax design of a CGT, the provisions of tax relief and exemptions were the tax experts' major concerns. These included:

- exemption for a taxpayer's main residence,
- adjustments for inflation,
- a general exemption for small gains, and
- deductions for capital losses and other necessary expenditure.

At the end of Phase Two, this study attempted to address the secondary research question, i.e., why (or why not) do the tax experts favour (or oppose) a comprehensive CGT? Twenty-three CGT adoption factors/issues were identified and grouped into 5 sub-categories i.e., 1) tax environment, 2) CGT structure, 3) tax evaluation, 4) social and political influences, and 5) international taxation.

The analysis revealed that the top three CGT adoption factors with the same level of significance are:

- high tax burden,
- negative political implications, and
- importance of private residence

In essence, the tax experts' decision for choosing the way to tax capital gains was significantly affected by these 3 non-CGT structural factors. Apart from these, there were other CGT factors such as the complexity of the CGT computation and the four evaluation factors (i.e., equity, revenue consideration, simplicity, and efficiency /neutrality). It is noted that stopping property speculation, which was ranked 7th out of the 23 factors, was one of the main reasons for the introduction of a CGT following the factor of equity.

7.2.3 Phase Three: comparative analysis of findings of Phases One and Two

In Phase Three, a number of key policy considerations were found in the comparative analyses. These are summarised below:

Haig-Simons' comprehensive income concept

One important finding was that capital gains were perceived as "something that's not income" by the tax experts. This contradicted to the Haig-Simons' comprehensive income concept which assumed there should be no distinction between income and capital gains. Hence, it was not surprising to find that a comprehensive CGT, which is based on the assumption of the Haig-Simons' income concept, was not supported by the tax experts. In particular, most tax experts strongly opposed an accrual-based CGT – the purest form of comprehensive CGT. They considered that such a tax system was not feasible in practice as they were concerned about the compliance costs involved in an accrual based CGT regime i.e., the annual valuation of all assets and the liquidity problems. Overall, the results revealed that the tax experts generally preferred the current hybrid income tax system.

Perceptions of fairness

A possible reason for the unpopularity of the Haig-Simons' comprehensive income concept and a comprehensive CGT could be that many tax experts considered it was unfair to tax all capital gains. In particular, some of the tax experts cast doubt on the horizontal equity principle for adopting a CGT. When evaluating the tax system, they had not adopted a traditional doctrine of "fairness". Instead, they perceived "fairness" as being not punitive. In their opinion, a fair tax system should not punish an individual's efforts for wealth creation. A good example of a "fair tax" was the flat tax system of the Goods and Services Tax (GST). However, this was not consistent with the concept of equity (particularly vertical equity) as GST was a regressive tax. Accordingly, for policy considerations, the tax experts preferred an income tax system similar to the GST system – simple and efficient. In theory, an ideal CGT system should include the broadest tax base and fewest exemption and incentives.

Tax planning opportunities

The absence of any CGT in New Zealand had provided significant tax planning opportunities. A number of tax experts considered that negative gearing for rental property was very common in New Zealand. Despite tax planning nature of negative gearing, most tax experts (particularly the tax practitioners) did not regard it as a tax avoidance arrangement. Nor did they find it illegal even though some of them agreed that it might seem as unfair by others.

Clarification of capital/income definitions

It was uncertain whether taxing capital gains would in fact clarify the distinction between capital gains and income. The minority CGT proponents tended to be more positive than the CGT opponents in this regard. In the interviews, most tax experts considered that, if a CGT were introduced, it would lead to more complicated capital/income boundary definition as the tax was complex and confusing.

Revenue protection of a CGT

The tax experts cast doubt on benefits of a CGT in terms of revenue protection. Although agreeing that a CGT would secure income tax revenue, the tax experts noted that the compliance costs of CGT would be very high and could exceed subsequent raised revenue. In particular, they were concerned about the low revenue yield of a CGT.

Double taxation

It was uncertain whether a CGT was double-taxing investors. The CGT opponents tended to be more inclined to agree that it was than the CGT proponents. The qualitative analysis suggested that CGT was perceived as another form of taxation, and was separated from the income tax. Therefore, the tax experts considered a CGT was not double-taxing the taxpayers.

Exemption of a taxpayer's main residence

All tax experts strongly supported the exemption of gains on disposal of a taxpayer's main residence. Due to the significance of home ownership in New Zealand, they considered it was unfair to tax principal residence as this would result in severe social injustice. Added to this, there was a strong political resistance to the taxation of gains on principal residence disposal. Overseas jurisdictions taxing capital gains had also generally exempted such capital gains. It would be a very challenging task from a political point of view not to exempt a taxpayer's main residence in practice.

Taxation of other real estate properties

In contrast to the taxation of principal residence, a majority of tax experts supported the taxation of capital gains on rental properties and land improvements. However, this support was limited to the extent where the taxpayers had intention or purpose for profit making. Some of the tax experts felt that it could be problematic to apply the subjective test of "intention" to determine the true nature of a transaction. Overall, the qualitative analysis suggested that the tax experts cast doubt on the effectiveness of the current tax regimes regarding the taxation of land and other real estate property transactions.

Tax relief for inflation adjustment

All tax experts strongly supported the provision of tax relief for inflation adjustment. They considered the lack of inflation adjustment as one of the major problems in the current tax system. In general, they perceived the negative impact of inflation on the tax system to be significant. Many of them believed that the general public suffered from the "poverty trap" due to the inflationary effect that dragged taxpayers into higher tax brackets as a result of the taxation of the nominal income instead of the real income. To reduce the tax burden on individual taxpayers, a tax relief for inflation adjustment was demanded by the tax experts. It is noted that the UK and Australia previously had implemented an indexation system in their CGTs. However, their systems were later replaced by a discount system. Nowadays, most OECD countries do not attempt to accurately adjust the effects of inflation. The main reasons for the trend are due partly to the complexity of an indexation system and partly to the belief that inflationary gains are no longer as significant as they once were in the 1970s.

CGT events and rollovers

It is noted that the tax experts were uncertain or neutral about the application of the CGT realisation events and CGT rollovers (non-realisation events). In fact, very few tax experts mentioned the CGT rollovers in the interviews. This uncertainty was reflected in their difficulty in understanding these technical aspects of the CGT system, particularly when specialised CGT knowledge was required.

International and future trends of CGT

The future of a comprehensive CGT is unclear. All tax experts recognised the lack of any comprehensive CGT in the New Zealand tax system had resulted in significant tax planning opportunities. However, the overall results found that most tax experts opposed the Haig-Simons' comprehensive income concept and the introduction of a comprehensive CGT. In particular, the tax experts generally disagreed that New Zealand would eventually follow the CGT approach of most trading countries, despite the fact that most OECD countries have a comprehensive CGT. It is interesting to note that, out of the 23 CGT adoption factors, the international taxation factor was the category least frequently cited by tax experts in the interviews. Only a minority of tax experts considered that tax harmonisation played an important role in policy setting.

Similarities of the CGT proponents' and opponents' responses

It is perhaps interesting to note that there were a large number of similarities in the responses of the proponents and the opponents. In fact, it was difficult to differentiate their positive CGT statements from their anti-CGT sentiments in some specific areas. For example, similarities in their responses were found in terms of the computation of CGT liability, CGT preferences, and the implementation of an accrual-based CGT. In other general areas, however, significant variances were evident such as the general CGT issues and the asset coverage. In terms of the 23 major CGT adoption factors, the tax experts often had more than one reasons to support their decision, and, ultimately, relied on these taxation and external factors/reasons to choose a particular CGT model, i.e., the status quo hybrid system or a more comprehensive CGT system. All in all, the tax experts generally reached an agreement on the arguments surrounding CGT (such as the capital/income boundary problem, its protection of the income tax base, and the complexity of the tax). They were concerned about practicality of the tax, and uncertain about the actual economic impact of a CGT to New Zealand as a whole.

7.3 Limitations

The study was, however, subject to the following limitations which must be considered when evaluating the results.

Sample size

The sample of tax experts was relatively small compared to the total size of the professional population, although in fact there are only a limited number of tax experts in New Zealand. As a result, this small sample size limits the ability to generalize the study's findings. In addition, the sample mainly comprised tax experts from the private and the education sectors (such as academics, registered tax agents and Chartered Accountants), while other tax experts from the government sector (such as the Inland Revenue and the Treasury) had been excluded. The latter group was excluded because of the possibility of a compromised position of the government officials. To a certain extent, the survey sample was likely to limit the ability to generalise in terms of these professionals too. However, it is noted that a number of the tax experts, particularly those who had participated in the interviews, had previous exposure to and experience of working in the public sector and was, therefore, likely to minimise such biased effects.

Explanatory power of the CGT adoption factors

The qualitative analysis revealed that there were 23 underlying factors/issues, both taxation and external, influencing the CGT adoption decision. While these factors were important to the respondents, the relative importance of its impacts upon the tax experts might be varied. The exploratory nature of this study has limited its explanatory and predictive powers in this regard.

7.4 Suggestions for further research

Future researches should re-examine the comprehensive income theory and consider alternative approaches to income definition in practice. For example, future studies may want to explore the relationship between the comprehensive income concept and the tax evaluation criteria (such as equity, efficiency, and simplicity). Another area worthy of investigation is the applicability of a dual income approach in the New Zealand context.

As no attempt was made to evaluate the attitudes of the whole tax community to a CGT, future research should survey the key stakeholders, including taxpayers and tax administrators. Additional researches are, therefore, needed to fine-tune or revise the proposed CGT model to reflect better community feedback.

Lastly, future researches can build a more sophisticated tax model by using micro-simulation techniques. Such researches would help to establish which models can best deliver the required policy outcomes with the assured revenue collection, while not breaching the equity, efficiency, and simplicity requirements.

7.5 Conclusion

This study had the objective of exploring the key issues, aspects, and attributes concerning CGT in New Zealand. It explored several important policy issues and reviewed their implication for the adoption of a CGT in New Zealand. This objective was achieved by investigating these issues in detail with special reference to the relevant literature, supporting documents and the tax experts' comments. It had also identified a number of important themes that could contribute to the existing knowledge.

The study revealed that the current tax system may be in need of a review, particularly regarding the issues surrounding the definition of capital gain, capital/income distinction, and the extent to which capital gains are taxed. It appears that the capital/income distinction may be a clear one for simple cases, but can be extremely difficult in other, border-line ones. The extent to which capital gains are taxed in the current tax system is heavily biased towards certain types of assets. As a result, tax experts, in practice, often have to exhaustively look through the legislation to check whether an item is taxable, and they are left with the assumption at the end that an item is not taxable if no applicable provision is found. The current approach creates ambiguity in the tax system. Moreover, the finding revealed that some of the tax provisions are complex and very hard to understand, particularly for the legislation concerning the taxation on land transactions, the international taxation, and the Accrual Rules. When dealing with some extremely difficult cases, such as the Accrual Rules, some tax experts simply ignore the provisions as they do not understand the details of the rules.

If capital gains were taxed as income, this would, in theory, avoid the aforementioned problems of distinguishing between income and capital receipts and reduce the erosion of the tax base. However, the overall results found that most tax experts opposed the introduction of a comprehensive CGT. In the tax experts' opinions, the main reasons for taxing capital gains were largely motivated by the notions of equity and the dampening effects on property speculation in the housing market. While nearly all of them recognised the significant tax planning opportunities due to the absence of any CGT, they were uncertain the introduction of a comprehensive CGT would solve all the problems and make the tax system fairer and more efficient as a whole.

One important finding was that the Haig-Simons' comprehensive income concept – which assumed there should be no distinction between income and capital gains – was not well-supported by the tax experts. In particular, most of them considered that a pure, comprehensive income system, i.e., an accrual-based CGT, was not feasible in practice as they were concerned about the compliance costs involved in an accrual based CGT regime e.g., the annual valuation of all assets and the liquidity problems. One possible explanation for the unpopularity of the Haig-Simons' comprehensive income concept was that many tax experts considered it was unfair to tax comprehensive capital gains. In particular, they did not agree with the benefits derived from the gain in horizontal equity through adopting such a CGT. In their opinions, a tax was considered as "fair" as long as it was not punitive. A good example of a "fair tax" was the flat tax system of the Goods and Services Tax (GST). This finding is ironic as most literature suggests that a GST is inconsistent with the concept of equity (particularly vertical equity) due to its regressivity.

However, a comprehensive CGT is not necessarily less acceptable, as shown by the quantitative data. After carefully exploring the tax experts' attitudes towards the formulation of a CGT, this study found that the top three CGT adoption factors (i.e., high tax burden, negative political implications and importance of private residence) that influenced the tax experts' decision for choosing the way to tax capital gains, were non-CGT structural ones. These findings were counter to existing perceptions that a CGT would be rejected because of its complexity and technical problems. It is, therefore, submitted that it is possible to implement a realisation-based CGT if one can determine the appropriate asset coverage and overcome the compliance problems.

These findings suggest that a revision of current tax literature is needed in order to incorporate these views when setting new tax policy, particularly in the New Zealand context. It is hoped that the knowledge gained in this study would give a greater understanding to practical decision-making that could result in a better public acceptance for a tax reform.

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Appendix A

Summary of the Four Government Reports

	Arguments for	Arguments against	Recommendations
The Ross Committee Report (1967)	The principle of equity supports the taxing of realised capital gains- "it is what you get, not how you get it, that should count for tax purposes". Absence of a CGT tends to encourage the holding of assets for speculative purposes rather than for productive purposes. Combating tax avoidance – eliminate those who try to covert taxable income into non taxable capital gain.	Definition problem – what should be/not to be subject to CGT Administration problem – computation of CGT Low revenue yield Disincentive effects on risk taking and growth investment	Generally supported a CGT but subject to further consultation. The possible design features of a CGT should include: o Net realised capital gains should be taxed and an accrual CGT only apply on the death of a taxpayer o All assets should be subject to CGT. Exemption applies to trading stock and principal residence o All types of taxpayers (i.e. individuals, companies and trustees) should all be treated on the same basis o 35% tax rate on asset sold within one year of acquisition and thereafter 30% reduced by 2% each year, until a minimum rate of 10% is reached o Realised capital losses should be deductible against current and future capital gains o A separate CGT Act is required
The McCaw Report (1982)	The principle of equity supports the taxing of realised capital gains- " (Capital) gains increase taxable capacity in just the same way as does a gain on income account". The lack of a CGT provided an incentive	Low revenue yield Problems of taxing nominal gains in the period of high inflation – this would probably bring more inequities than it would cure	The Committee opposed the introduction of a CGT on grounds of "equity". It considered the existing tax provisions, which had already covered most capital gains, reduced the need for a specific CGT.

	Arguments for	Arguments against	Recommendations
	for funds to be diverted from productive activities to unproductive investments offering prospects of capital appreciation.		
The Valabh Committee (1988)	The notion of horizontal equity supports the introduction of a CGT. Taxpayers deriving income from capital gains should bear the same tax burden as those earning taxable ordinary income. On the efficiency and neutrality grounds, the tax treatment of investments which yielded capital gains would be aligned with the treatment of other investments. Different to the McCaw Committee, the Valabh Committee argued that a CGT would raise more revenue. A CGT would protect the income tax base by reducing the taxpayers' incentives to convert otherwise taxable income into non-taxable capital gains.	It recommended a realisation-based CGT which was considered to be more practical than an accrual based CGT. It believed that the administrative problems of requiring taxpayers to provide market valuation of assets, particularly for those which were difficult to value, would be more complicated under an accrual system. However, it recommended a continued investigation of an accrual approach because of the lock-in problem of realisation-based system.	It recommended the introduction of a realisation-based CGT. The possible design features of a CGT should include: o Comprehensive CGT with indexation which applied to all forms of income from capital o Special tax treatments on: (1) Residence – full taxation with an indexed standard annual allowance (such as $4,000) and deduction for expenditure incurred on capital improvements; (2) Household durables (e.g., cars, boats and other household durables) would be exempt; and (3) Jewellery, fine art and collectables – full taxation with a small exemption threshold for administrative reasons. o As an anti-avoidance measure, capital losses would need to be ring-fenced- losses. o Deemed realisation on death, gifting, involuntary transfer of ownership, or where an asset was leased on a long-term basis. o The only rollover relief available was the

	Arguments for	Arguments against	Recommendations
			transfer within a wholly-owned group of companies
The McLeod Report (2001)	It agreed and accepted the arguments put forward by the Valabh Committee "on a theoretical level"	The concept of comprehensive income was "a theoretical concept that can never be fully achieved under any real-world income tax" Measurement problem under an accrual based CGT A realisation-based CGT was a transactional tax on the disposal of assets and far from the theoretical ideal of a CGT (i.e., an accrual based CGT). Moreover, it was complex and costly to operate, and reduced the effectiveness of a CGT. Technical problems on: o Deductibility of capital losses: Strong incentive to defer realisation and, therefore, reduction in tax revenue and unproductive use of assets. o CGT realisation event: Arbitrary and very difficult to define all possible events o Rollover relief: Not economically desirable to provide rollovers in all situations o Asset coverage: Defining classes of assets and the cost measurement could be problematic especially for an intangible property.	The Committee opposed the introduction of a CGT. However, it identified four significant gaps in the income tax base where the inconsistencies in the tax treatment of capital gains created problems. These were: o The inconsistent treatment of different saving vehicles o The impact on the treatment of offshore investment o The possible effects on investment in housing; and o The likely opportunities that taxpayers might use to transform otherwise taxable income into capital gains in the absence of a CGT. It recommended the adoption of a Risk-Free Return Method (RFRM) to address problem areas such as designated investment vehicles and residential housing.

	Arguments for	Arguments against	Recommendations
		Overseas experience suggested that: o CGTs "tend to be some of the most complex areas of tax law" and needed to be "interpreted and applied by taxpayers of relatively modest means" o CGT was perceived as "being unfair or unreasonable". o Constant legislative changes on CGT resulted in "increasing arbitrariness in the application of the law". o Compliance costs appeared to be disproportionate to the amount of revenue raised.	

Appendix B

Ethical Approval

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THE UNIVERSITY OF
WAIKATO
Te Whare Wānanga o Waikato

MANAGEMENT SCHOOL
Te Raupapa

2nd May 2005

Alvin Cheng

Hamilton

Dear Alvin

Ethical Application WMS 05/29
"Taxation of Capital Gains in New Zealand"

As per Dr Costley's earlier email the above research project has been granted Ethical Approval for Research, with suggested modifications.

Best wishes for your research

Regards,

Amanda Sircombe
Research Manager

Appendix C

Tax Teacher Survey

Alvin Cheng
Accounting Department
Waikato Management School
University of Waikato
Hamilton

5/1/2005

Dear Sir/Madam,

I am a PhD student at the University of Waikato. The focus of my PhD thesis is to explore current thinking about taxation of capital gains. Due to the complexity of the topic, your professional views and ideas will be most helpful. The result of this questionnaire will be used in my thesis.

The purpose of this questionnaire is to seek your ideas on how a capital gains tax (CGT) could be handled in New Zealand if one were to be implemented. **It does not suggest or propose a CGT**. My focus is on the technical side of taxing capital gains and with your assistance, it is hoped that a deeper insight into the technical problems and possibilities will result. All information will be treated confidentially and respondents' anonymity will be preserved.

Your cooperation is greatly appreciated and the completed questionnaire should be returned to me by 8th February 2005. Reply paid envelope is enclosed for your convenience. If you have any enquiry, please don't hesitate to contact me.

Yours sincerely,

Alvin Cheng

Capital Gains Tax

I am interested to know your views on how a capital gains tax (CGT) could be handled in New Zealand if one were to be implemented.

Part 1. Capital Gains Tax (CGT) – General Issues

	Strongly disagree		Neutral		Strongly agree
1. As most of our trading countries have a CGT, implementation of a CGT is inevitable	1	2	3	4	5
2. Taxing capital gains will clarify (and possibly remove) the distinction between capital gains and income, therefore it reduces the uncertainty in the application of the tax law	1	2	3	4	5
3. The absence of any CGT in New Zealand provides significant opportunities for tax planning	1	2	3	4	5
4. CGT will raise revenue for the government if only by protecting the income tax base	1	2	3	4	5
5. CGT is double taxing investors as the money they invest in a business has already been taxed	1	2	3	4	5
6. Capital gains and income should be taxed on the same basis	1	2	3	4	5

Part 2. How to tax capital gains

The first section covers questions about a realisation based CGT[51] while the second section deals with an accrual based CGT[52].

[51] A realisation based CGT is a tax system where capital gains are taxed when they are realised i.e. the tax is triggered when a taxpayer sells or disposes of a property.

[52] An accrual based CGT is a tax system where the **unrealised** capital gain of a taxpayer's CGT assets, which is computed as the difference between the fair market value and its cost, is taxed annually. It does not matter if the taxpayer actually has not sold/disposed of the CGT asset.

Section 1: Realisation basis

In this section, consider a CGT system where capital gains are taxed when they are realised i.e. the tax is triggered after the disposal of a property.

1-1. Asset Coverage (Realisation basis)

Do you think the following assets should be included for CGT purposes and what should the exempt amount be?

	No	Yes, this item should be included for CGT purposes if the capital proceeds is greater than the amount of:						Or specify if you wish
• Any chose in action (whether legal or equitable)	No	$0	$1-50,000	$50,001-150,000	$150,001-300,000	$300,001-500,000	Above $500,001	________
• Business goodwill	No	$0	$1-50,000	$50,001-150,000	$150,001-300,000	$300,001-500,000	Above $500,001	________
• Collectables e.g. jewellery, stamps	No	$0	$1-1,000	$1,001-5,000	$5,001-10,000	$10,001-50,000	Above $50,001	________
• Copyrights and patents	No	$0	$1-1,000	$1,001-5,000	$5,001-10,000	$10,001-50,000	Above $50,001	________
• Debt owed to a taxpayer (ignore the implications of the accruals rules)	No	$0	$1-1,000	$1,001-5,000	$5,001-10,000	$10,001-50,000	Above $50,001	________
• Farms	No	$0	Below $500,000	$500,000-$1million	$1m-5million	$5m-10million	Above $10million	________
• Land improvements	No	$0	$1-50,000	$50,001-150,000	$150,001-300,000	$300,001-500,000	Above $500,001	________
• Listed bonds and capital notes	No	$0	$1-1,000	$1,001-5,000	$5,001-10,000	$10,001-50,000	Above $50,001	________
• Personal-use property e.g. home appliance, private car	No	$0	$1-1,000	$1,001-5,000	$5,001-10,000	$10,001-50,000	Above $50,001	________
• Private home (main residence)	No	$0	$1-100,000	$100,001-250,000	$250,001-500,000	$500,001-1,000,000	Above $1,000,001	________
• Rental home	No	$0	$1-100,000	$100,001-250,000	$250,001-500,000	$500,001-1,000,000	Above $1,000,001	________
• Second home e.g. beach house	No	$0	$1-100,000	$100,001-250,000	$250,001-500,000	$500,001-1,000,000	Above $1,000,001	________
• Shares in a listed company	No	$0	$1-1,000	$1,001-5,000	$5,001-10,000	$10,001-50,000	Above $50,001	________
• Shares in a small company (non-listed)	No	$0	$1-1,000	$1,001-5,000	$5,001-10,000	$10,001-50,000	Above $50,001	________
• Share rights and options	No	$0	$1-1,000	$1,001-5,000	$5,001-10,000	$10,001-50,000	Above $50,001	________

1-2. Defining a realising event (Realisation basis)	**Strongly disagree**		**Neutral**		**Strongly agree**
Do you think the following situation/event should be regarded as a "disposal" of property by a taxpayer?					
• Assets-for-shares acquisition[53]	1	2	3	4	5
• Business relocation[54]	1	2	3	4	5
• Gifting away the asset (ignore the implications of the Gift Duty)	1	2	3	4	5
• Incorporation of a company[55]	1	2	3	4	5
• Insurance payment for destroyed property	1	2	3	4	5
• Involuntary disposition e.g. compulsory acquisition by the government	1	2	3	4	5
• Like-kind property exchange	1	2	3	4	5
• Liquidations including the situation where a wholly owned subsidiary is wound-up into its parent	1	2	3	4	5
• Reinvestment in replacement property	1	2	3	4	5
• Renewal of a lease agreement	1	2	3	4	5
• Share-for-share exchanges[56]	1	2	3	4	5
• Termination of a contract	1	2	3	4	5
• Transfers of assets between related parties including spousal transfer	1	2	3	4	5
• When a taxpayer ceases to be a tax resident in New Zealand	1	2	3	4	5

[53] A situation where a company takes over another by exchanging its shares for assets of the target company

[54] A situation where pursuant to company law a company ceases to be incorporated in one jurisdiction and becomes reincorporated in another jurisdiction

[55] A situation where a sole trader or partnership transfers business assets into a company and takes back shares

[56] A situation where one company acquires another by offering shares in itself to the shareholders of the target company

Realisation Basis- **1-3 Computation of CGT and Tax Relief**	**Strongly disagree**		**Neutral**		**Strongly agree**
• Do you think the cost base should be adjusted for inflation e.g. indexation for capital gains?	1	2	3	4	5
• Do you think a deemed "market value" should be applied on the disposal price when there is lack or no consideration? (e.g. non-arm-length transaction and gifts)	1	2	3	4	5
• Do you think a tapering discount (i.e. the longer the taxpayer holds an asset, the lesser the tax liability) should be provided in order to reduce the lock-in effect?	1	2	3	4	5
• Do you think an averaging relief (i.e. the liability of CGT is spread over several years to avoid the accumulation of a big capital gain in one year) should be provided in order to reduce the bunching effect?	1	2	3	4	5
• Do you think a tax relief should be provided for disposal of a small business (e.g. turnover of less than $1 million)?	1	2	3	4	5
• Do you think a tax relief should be provided for new/innovative business venture?	1	2	3	4	5

Section 2: Accrual basis
In the next section, consider a CGT system where **unrealized** capital gains are taxed annually.

Accrual basis	**Strongly disagree**		**Neutral**		**Strongly agree**
2-1. Do you think an objective market price is obtainable for the following assets?					
• Commercial property	1	2	3	4	5
• Collectibles e.g. jewellery, stamps	1	2	3	4	5

Accrual basis	Strongly disagree		Neutral		Strongly agree
• Farms	1	2	3	4	5
• Financial instruments (listed) e.g. bonds and capital notes	1	2	3	4	5
• Intangible assets e.g. patents and copyright	1	2	3	4	5
• Personal-use property e.g. home appliance and private car	1	2	3	4	5
• Residential property	1	2	3	4	5
• Shares in a listed company	1	2	3	4	5
• Shares in a small company (non-listed)	1	2	3	4	5
2-2. Where an objective market price of an asset is not available, an interest charge should be imposed on the capital gain of the disposal of such asset at the time of the disposal.	1	2	3	4	5

2-3. If you **disagree (scale of 1)** with question 2-2, please skip this question and go to question 2-4. Otherwise, what type of interest rate should be applied?

(Please tick appropriate box)

Inflation rate ☐
Internal rate of return of the investment ☐
Risk free rate i.e. interest rate from government bond ☐

2-4. Do you think taxpayers will suffer liquidity problems under an accrual-basis tax because they have not yet converted the gain to cash?	1	2	3	4	5

Part 3: Building a CGT system

(Please tick appropriate box)

1. Do you prefer a realisation based CGT or an accrual based (unrealised gains) CGT?

Realised CGT ☐ Accrual CGT ☐

2. Should CGT be integrated into the income tax system or should it be a separate tax?

Part of income tax ☐ A separate tax ☐

(Please tick appropriate box)

3. What tax rates should be applied for capital gains?

Higher than income tax rates ☐
Ordinary income tax rates ☐
Lower than income tax rates ☐

4. Calculating the cost	Strongly disagree		Neutral		Strongly agree
Which of the following should be included in the cost of an asset for CGT purposes?					
• Agent fees e.g. commission and brokerage	1	2	3	4	5
• Contingent liabilities	1	2	3	4	5
• Debts to finance the property	1	2	3	4	5
• Improvement expenditure for property	1	2	3	4	5
• Interest for financing the property	1	2	3	4	5
• Legal fees and stamp duty	1	2	3	4	5
• Market value of any property a taxpayer gave or is required to give in respect of acquiring a CGT asset	1	2	3	4	5
• Purchase price	1	2	3	4	5
• Repair and maintenance expenses	1	2	3	4	5
6. Do you think capital loss should be regarded as a deductible expense which can be set against gross income?	1	2	3	4	5

7. What should be the treatment for unused capital losses?
(Please tick on one of the boxes only)

Individual taxpayers	Tax refund	☐	Carry forward	☐
Corporate taxpayers	Tax refund	☐	Carry forward	☐

Tax relief

8. Do you think a general exemption should be provided for small gains (e.g. the total of capital gains of a taxpayer is less than $1,000) because of administrative simplicity?	1	2	3	4	5
9. Do you think a partial exemption should be provided for the disposal of active assets of a small business (whose annual turnover is less than $1 million)?	1	2	3	4	5

International Taxation

	Strongly disagree		Neutral		Strongly agree
10. Do you think New Zealand tax residents' overseas assets should be included for CGT purposes?	1	2	3	4	5
11. Do you think non-residents should pay CGT if they earn capital gains from disposing of New Zealand assets?	1	2	3	4	5

Integration with other legislation

12. Do you think CGT paid at the company level should be transferred to the shareholders as CGT credits?	1	2	3	4	5
13. Do you think the following section of the legislation should be repealed if CGT is introduced?					
• Accruals rules	1	2	3	4	5
• CD1 land transaction	1	2	3	4	5
• CD 4 personal property	1	2	3	4	5
• Controlled foreign companies (CFC) and foreign investment funds regime (FIF)	1	2	3	4	5
• Gift duty	1	2	3	4	5

Part 4. Please indicate your background.

Name:

Name of Institution:

1. What is/are you specializing area(s)?

- ❑ Auditing
- ❑ Business consultancy
- ❑ Costing
- ❑ Financial accounting
- ❑ Legal advice
- ❑ Management
- ❑ Taxation
- ❑ Others

2. Are you willing to participate in further interview? Yes ☐ NO ☐

Please feel free to add other comment or observation

Thank you very much for your help!

Please return to: Alvin Cheng, Accounting Department, University of Waikato

Appendix D

Tax Practitioner Survey

Alvin Cheng
Accounting Department
Waikato Management School
University of Waikato
Hamilton

27/10/2005

Dear Sir/Madam,

I am a PhD student at the University of Waikato and my supervisor is Professor Howard Davey. The focus of my PhD thesis is to explore current thinking about taxation of capital gains. Due to the complexity of the topic, your professional views and ideas would be most helpful. If you have already completed this questionnaire, please do not complete it again.

The purpose of this questionnaire is to seek your ideas on how a capital gains tax (CGT) could be handled in New Zealand if one were to be implemented. It does not suggest or propose a CGT. My focus is on the technical side of taxing capital gains and with your assistance, it is hoped that a deeper insight into the technical problems and possibilities will result.

All information will be treated confidentially and respondents' anonymity will be preserved. Your anonymity will be protected by the code number system which will be used for both data analysis and the reporting and publication of data. Your completed questionnaire will be kept in a locked cabinet. You will be provided with a summary of findings at the conclusion of the study. The evidence collected in this research will be contribute toward my PhD thesis and may be used for further research.

Your cooperation is greatly appreciated. Please return the completed questionnaire to me by 10th November 2005. Reply paid envelope is enclosed for your convenience.

If you have any queries, please do not hesitate to contact me.

Yours sincerely,

Alvin Cheng

Practitioner Capital Gains Tax Survey

Background Information **(Please answer all questions by ticking the appropriate box)**		
Name: ______________________________ Name of your organisation: ______________________________ ______________________________	2. You are ❑ A Chartered Accountant ❑ A legal practitioner ❑ A registered tax agent ❑ Other (Please describe) ______________________	2. Your area(s) of speciality ❑ Auditing ❑ Business consultancy ❑ Costing & management ❑ Financial accounting ❑ Legal advice ❑ Taxation ❑ Other _________________
	3. Years of practicing in Taxation _____	

(Please move to next page)

I am interested to know your views on how a capital gains tax (CGT) could be handled in New Zealand if one were to be implemented.

Part 1. Capital Gains Tax (CGT) – General Issues

	Strongly disagree		Neutral/ Don't know		Strongly agree
1. As most of our trading countries have a CGT, implementation of a CGT is inevitable in New Zealand	1	2	3	4	5
2. Taxing capital gains will clarify (and possibly remove) the distinction between capital gains and income, therefore it reduces the uncertainty in the application of the tax law	1	2	3	4	5
3. The absence of any CGT in New Zealand provides significant opportunities for tax planning	1	2	3	4	5
4. CGT will raise revenue for the government if only by protecting the income tax base	1	2	3	4	5
5. CGT is double taxing investors as the money they invest in a business has already been taxed	1	2	3	4	5
6. Capital gains and income should be taxed on the same basis	1	2	3	4	5

Part 2. How to tax capital gains

The first section covers questions about a realisation based CGT[57] while the second section deals with an accrual based CGT[58].

Section 1: Realisation basis

In this section, consider a CGT system where capital gains are taxed when they are realised i.e. the tax is triggered after the disposal of a property.

[57] A realisation based CGT is a tax system where capital gains are taxed when they are realised i.e. the tax is triggered when a taxpayer sells or disposes of a property.

[58] An accrual based CGT is a tax system where the **unrealised** capital gain of a taxpayer's CGT assets, which is computed as the difference between the fair market value and its cost, is taxed annually. It does not matter if the taxpayer actually has not sold/disposed of the CGT asset.

1-1. Asset Coverage (Realisation basis)

Do you think the following assets should be included for CGT purposes? Please circle your response. If your answer is Yes, please specify the threshold for the exemption of the capital gain (if any).

		If yes, the exemption is: (put zero for no exemption)
• Any chose in action (legal or equitable)	Yes / No	$
• Business goodwill	Yes / No	$
• Collectables e.g. jewellery, stamps	Yes / No	$
• Copyrights and patents	Yes / No	$
• Debt owed to a taxpayer (ignore the implications of the accruals rules)	Yes / No	$
• Farms	Yes / No	$
• Land improvements	Yes / No	$
• Listed bonds and capital notes	Yes / No	$
• Personal-use property e.g. home appliance, private car	Yes / No	$
• Private home (main residence	Yes / No	$
• Rental home	Yes / No	$
• Second home e.g. beach house	Yes / No	$
• Shares in a listed company	Yes / No	$
• Shares in a small company (non-listed)	Yes / No	$
• Share rights and options	Yes / No	$

1-2. Defining a realising event (Realisation basis)

Do you think the following situation/event should be regarded as a "disposal" of property by a taxpayer?

	Strongly disagree		Neutral/ Don't know		Strongly agree
• Assets-for-shares acquisition[59]	1	2	3	4	5
• Business relocation[60]	1	2	3	4	5
• Gifting away the asset (ignore the implications of the Gift Duty)	1	2	3	4	5
• Incorporation of a company[61]	1	2	3	4	5
• Insurance payment for destroyed property	1	2	3	4	5
• Involuntary disposition e.g. compulsory acquisition by the government	1	2	3	4	5
• Like-kind property exchange	1	2	3	4	5
• Liquidations including the situation where a wholly owned subsidiary is wound-up into its parent	1	2	3	4	5
• Reinvestment in replacement property	1	2	3	4	5
• Renewal of a lease agreement	1	2	3	4	5
• Share-for-share exchanges[62]	1	2	3	4	5
• Termination of a contract (ignore the implications of the accruals rules)	1	2	3	4	5
• Transfers of assets between related parties including spousal transfer	1	2	3	4	5
• When a taxpayer ceases to be a tax resident in New Zealand	1	2	3	4	5

[59] A situation where a company takes over another by exchanging its shares for assets of the target company

[60] A situation where pursuant to company law a company ceases to be incorporated in one jurisdiction and becomes reincorporated in another jurisdiction

[61] A situation where a sole trader or partnership transfers business assets into a company and takes back shares

[62] A situation where one company acquires another by offering shares in itself to the shareholders of the target company

Realisation Basis-
1-3 Computation of CGT and Tax Relief

	Strongly disagree		Neutral/ Don't know		Strongly agree
• Do you think the cost base should be adjusted for inflation e.g. indexation for capital gains?	1	2	3	4	5
• Do you think a deemed "market value" should be applied on the disposal price when there is lack or no consideration? (e.g. non-arm-length transaction and gifts)	1	2	3	4	5
• Do you think a tapering discount (i.e. the longer the taxpayer holds an asset, the lesser the tax liability) should be provided in order to reduce the lock-in effect?	1	2	3	4	5
• Do you think an averaging relief (i.e. the liability of CGT is spread over several years to avoid the accumulation of a big capital gain in one year) should be provided in order to reduce the bunching effect?	1	2	3	4	5
• Do you think a tax relief should be provided for disposal of a small business (e.g. turnover of less than $1 million)?	1	2	3	4	5
• Do you think a tax relief should be provided for new/innovative business venture?	1	2	3	4	5

Section 2: Accrual basis (unrealised capital gains tax)

In the next section, consider a CGT system where unrealised capital gains are taxed annually. An accrual based CGT is a tax system where the unrealised capital gain of a taxpayer's CGT assets, which is computed as the difference between the fair market value and its cost, is taxed annually, i.e. **capital gain = market value – cost**. It does not matter if the taxpayer actually has not sold/disposed of the CGT asset.

Accrual basis	Strongly disagree		Neutral/ Don't know		Strongly agree
2-1. Do you think an objective market price is obtainable for the following assets?					
• Commercial property	1	2	3	4	5
• Collectibles e.g. jewellery, stamps	1	2	3	4	5
• Farms	1	2	3	4	5
• Financial instruments (listed) e.g. bonds and capital notes	1	2	3	4	5
• Intangible assets e.g. patents and copyright	1	2	3	4	5
• Personal-use property e.g. home appliance and private car	1	2	3	4	5

Accrual basis	Strongly disagree		Neutral/ Don't know		Strongly agree
• Residential property	1	2	3	4	5
• Shares in a listed company	1	2	3	4	5
• Shares in a small company (non-listed)	1	2	3	4	5

2-2. What action should be taken to tax the accrual/ unrealised capital gain when an objective market price of an asset is not available?

- No CGT i.e. exempt such a gain---------------- ☐
- A realisation based CGT------------------------- ☐
- A realisation based CGT plus use of money interest-inflation rate i.e. 3% p.a.--------------- ☐
- A realisation based CGT plus use of money interest- internal rate of return of the asset---- ☐
- A realisation based CGT plus use of money interest- risk-free return rate i.e. interest rate from government bond at say 6.5% p.a.------- ☐

(Please tick one box only)

2-3. Do you think taxpayers will suffer liquidity problems under an accrual-basis tax because they have not yet converted the gain to cash?	1	2	3	4	5

Part 3: Building a CGT system

1. Of the different forms of tax, please indicate your level of support for the following:

• Status quo	1	2	3	4	5
• Comprehensive realisation based CGT	1	2	3	4	5
• Comprehensive accrual based CGT	1	2	3	4	5

(Please tick appropriate box)

2. Should CGT be integrated into the income tax system or should it be a separate tax?

Part of income tax ☐ A separate tax ☐

3. What tax rates should be applied for capital gains?

Higher than income tax rates ☐
Ordinary income tax rates ☐
Lower than income tax rates ☐

4. Calculating the cost	Strongly disagree		Neutral/ Don't know		Strongly agree
Which of the following should be included in the cost of an asset for CGT purposes?					
• Agent fees e.g. commission and brokerage	1	2	3	4	5
• Contingent liabilities	1	2	3	4	5
• Debts to finance the property	1	2	3	4	5
• Improvement expenditure for property	1	2	3	4	5
• Interest for financing the property	1	2	3	4	5
• Legal fees and stamp duty	1	2	3	4	5
• Market value of any property a taxpayer gave or is required to give in respect of acquiring a CGT asset	1	2	3	4	5
• Purchase price	1	2	3	4	5
• Repair and maintenance expenses	1	2	3	4	5
5. Do you think capital loss should be regarded as a deductible expense which can be set against gross income?	1	2	3	4	5

6. What should be the treatment for unused capital losses?

(Please tick on one of the boxes only)

Individual taxpayers	Tax refund	☐	Carry forward	☐
Corporate taxpayers	Tax refund	☐	Carry forward	☐

Tax relief

7. Do you think a general exemption should be provided for small gains (e.g. the total of capital gains of a taxpayer is less than $1,000) because of administrative simplicity?	1	2	3	4	5
8. Do you think a partial exemption should be provided for the disposal of active assets of a small business (whose annual turnover is less than $1 million)?	1	2	3	4	5

International Taxation

9. Do you think New Zealand tax residents' overseas assets should be included for CGT purposes?	1	2	3	4	5

International Taxation	Strongly disagree		Neutral/ Don't know		Strongly agree
10. Do you think non-residents should pay CGT if they earn capital gains from disposing of New Zealand assets?	1	2	3	4	5

Integration with other legislation

11. Do you think CGT paid at the company level should be transferred to the shareholders as CGT credits?	1	2	3	4	5
12. Do you think the following section of the legislation should be repealed if CGT is introduced?					
• Accruals rules	1	2	3	4	5
• CD1 land transaction	1	2	3	4	5
• CD 4 personal property	1	2	3	4	5
• Controlled foreign companies (CFC) and foreign investment funds regime (FIF)	1	2	3	4	5
• Gift duty	1	2	3	4	5

The second phase of the research involves a semi-structured interview. This will take about one hour of your time. If you are happy to be contacted for an interview, please tick the box.

I am interested in participating in an interview? ❑ Yes ❑ No

Your contact details:

E-mail: ______________________________ Telephone: (____)_______________

Postal Address: ____________________________________

Please feel free to add other comment or observation

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Thank you very much for your help!

Please return to: Alvin Cheng, Accounting Department, University of Waikato

Appendix E

Interview

Alvin Cheng
Accounting Department
Waikato Management School
University of Waikato
Hamilton

16/12/2005

Dear,

Thank you for completing my questionnaire, and indicating that you would be willing to participate in an interview. The interview will be confidential and anonymity will be preserved. It is a face to face interview and will be arranged at a time and place convenient to you. It will take about half an hour to an hour of your time.

An information sheet is enclosed in this letter. It will give you some ideas of how the interview will be conducted and what kind of questions that I am going to ask you.

I will be away for a month from 25th January and will be available before and after that period. Please could you indicate preferred time(s) and location for the interview by email (preferred) or by mail using the enclosed reply paid envelope.

Kind regards,

Alvin Cheng

Department of Accounting
Waikato Management School
The University of Waikato
Private Bag 3105
Hamilton, New Zealand

The University of Waikato
Te Whare Wānanga o Waikato

Taxation of Capital Gains PhD Research Information Sheet

Overview
I am a PhD student at the University of Waikato. The focus of my PhD thesis is to explore current thinking about taxation of capital gains.

Who's responsible?
My name is Alvin Cheng. You can phone me at xxx, email: @waikato.ac.nz or contact me at the address on the letterhead. My Supervisor is Howard Davey. His phone number is xxx, email @waikato.ac.nz.

What's the research study about?
As a part of my PhD study, the focus of this project is to explore current thinking about taxation of capital gains in New Zealand. This will involve examination of the structure and effects of the present tax system in New Zealand. The purpose of this project is to explain the current phenomena of non-taxation of capital gains in New Zealand by investigating theory and actual practice.

What will you have to do and how long will it take?
It is a semi-structured interview and will require about one hour of your time. Before undertaking the interview, I will ask you to sign a consent form giving permission for me to tape record the interview and use the tape for transcription purposes and analysis for my research. During the interview, I will first ask you questions about the current tax system in general, which may or may not be related to taxation of capital gains. Then, I will seek your opinions on improving the tax system. Lastly, I will ask you to make predictions about what will happen, if capital gains tax was in New Zealand. Since it is a semi-structured interview, you are welcome to raise new issues you feel are important during our discussion.

What will happen to the information collected?
The survey and interview will be confidential. Your name and address will not be used in my PhD work. All recorded material will be treated with the strictest confidentiality. Only my supervisor and I will have access to the material. All completed questionnaire, consent form and tape-recording transcript will be stored in my locker and will be destroyed at your request.

Declaration to participants
If you take part in the study, you have the right to:

- Refuse to answer any particular question, and to withdraw from the study at any time.
- Ask any further questions about the study that occur to you during your participation.
- Be given access to a summary of the findings from the study when it is concluded.

Consent Form for Participants

Waikato Management School
Te Raupapa

THE UNIVERSITY OF WAIKATO
Te Whare Wānanga o Waikato

Taxation of Capital Gains

Consent Form for Participants

I have read the Information Sheet for Participants for this study and have had the details of the study explained to me. My questions about the study have been answered to my satisfaction, and I understand that I may ask further questions at any time.

I also understand that I am free to withdraw from the study at any time, or to decline to answer any particular questions in the study. I agree to provide information to the researcher under the conditions of confidentiality set out on the Information Sheet.

- ☐ *I agree to participate in this study under the conditions set out in the Information Sheet form.*

- ☐ *I grant permission for the interview to be tape recorded and transcribed, and to be used for the purposes set out in the Information Sheet.*

Signed: ____

Name: ____

Date: ____

Researcher's Name and contact information:

Alvin Cheng