

# **IS THERE A CASE FOR A COMPREHENSIVE CAPITAL GAINS TAX IN NEW ZEALAND?**

Daniel Hunt

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**Primary Supervisor: Chris Ohms**

**Secondary Supervisor: Louise Longdin**

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## **Attestation of Authorship**

I hereby declare that this submission is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person (except where explicitly defined in the acknowledgements), nor material which to a substantial extent has been submitted for the award of any other degree or diploma of a university or other institution of higher learning.

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Daniel Hunt

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## **Abstract**

This dissertation investigates and explores whether or not a comprehensive capital gains tax (CGT) should be introduced into New Zealand, looking in depth at whether a CGT should be introduced on an accrual or realisation basis. It will consider and critically analyse the extent to which New Zealand currently taxes capital gains and compare this with other OECD countries that have a CGT regime in place (namely Canada and Australia). This dissertation will seek to define the concept of income from a legal, economic and accounting perspective. It will also consider proposals put forward by the Tax Working Group (TWG).

## Introduction

Henry Simons, an American tax philosopher once said:

“Tax laws do not really define income but merely set up rules as to what must be included and what must be deducted; and such rules by no means define income because they are neither exhaustive nor logically coherent”.<sup>1</sup>

The above statement is well illustrated by the current New Zealand tax laws. The proper income tax treatment of capital gains has raised much debate and controversy amongst New Zealanders. A capital gain is defined as “...a gain that arises when an item of property appreciates in value or when the price of the realised property exceeds its acquisitions cost”.<sup>2</sup>

New Zealand currently has tax regimes in place which tax specific capital gains to varying degrees including certain land transactions, personal property (i.e. shares), financial instruments (through the financial arrangement tax regime) and foreign shares (through the fair dividend rate).

However, New Zealand is unique in comparison with other countries such as Australia which has a similar economic, social and democratic environment in that New Zealand does not have a comprehensive CGT. While this in itself does not justify the introduction of such a tax in New Zealand, it does indicate there is considerable support at large for such a tax and that the New Zealand tax system may be a step behind in its evolution.

To a large extent, many capital gains are already taxed in New Zealand by way of specific provisions of the Income Tax Act 2007 such as gains arising from the sale of personal property and those arising from the sale of land. However, in the absence of

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<sup>1</sup> Henry C. Simons *Personal Income Taxation: the Definition of Income as a Problem of Fiscal Policy* (University of Chicago Press, Chicago 1938) at 105.

<sup>2</sup> Paul Singleton “Should New Zealander’s be Burdened With an Even More Comprehensive Capital Gains Tax?” (2003) 9 NZJTL 42.



specific provisions indicating otherwise, the Act imposes tax on profits or gains of an income (revenue) nature and not those of a capital nature.

Within New Zealand, the ill-defined capital/revenue boundary has created much uncertainty as to whether gains are of a capital or revenue nature leading to many avoidance disputes between taxpayers and the Inland Revenue. The distinction between capital and income has always been one of the keys to the interpretation and application of the Act. As the Privy Council noted in *BP Australia Limited v FCT*,<sup>3</sup> the distinction is sometimes difficult to draw between profit that is made “out of” assets and profit that is made “upon” assets.

The fundamental question of whether a comprehensive CGT should be introduced in New Zealand and to what extent is one which has raised much debate and controversy among taxpayers and academics throughout the country.<sup>4</sup>

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<sup>3</sup> *BP Australia Ltd v Federal Commissioner of Taxation* (1965) 112 CLR 387.

<sup>4</sup> Roger Douglas “Morgan Onboard for Capital Tax Proposal” (press release, 2 December 2009) <[www.scoop.co.nz](http://www.scoop.co.nz)>, Roger Kerr “Little to Gain From Tax on Housing” (8 October 2009) New Zealand Herald <[www.nzherald.co.nz](http://www.nzherald.co.nz)>, Garry Sheeran “Capital Gains Tax Debate Heats Up” *Sunday Star Times* (New Zealand, 9 August 2009) 14, Rick Krever and Neil Brooks, *A Capital Gains Tax for New Zealand* (Victoria University Press, Wellington, 1990) and Paul Kenny “Capital Gains Taxation for New Zealand: Fairer and More Efficient” (2001) 7 NZJTL 265.

## Part 1: Capital Gains in New Zealand

### Introduction

New Zealand is one of the few remaining countries in the OECD<sup>5</sup> that does not have a comprehensive CGT and thus relies on a rather narrow income tax base.<sup>6</sup> Traditionally, New Zealand appears to have shown little interest in adopting a comprehensive CGT and a CGT was not part of the initial tax implementation design. The early legislation<sup>7</sup> failed to include capital gains as taxable income and subsequent reports produced did not deal extensively with the taxation of capital gains.<sup>8</sup>

In fact, several reports on taxation in New Zealand over the past 20 years have not even considered a capital gains tax. It wasn't until 1966, that the third report from the Ross Committee Review approached the idea of a capital gains tax. This was the first report that considered and recommended that capital gains be included in income. It called for public consultation and further study before implementation and stated that "...the introduction of a realised capital gains tax is desirable on the grounds of equity provided the rates of tax are moderate".<sup>9</sup>

In 1982, the fourth review undertaken by the McCaw Committee found that there was no need to introduce CGT as it yielded little revenue and would rather add complexity and produce inequities in terms of inflation. In 1987, by contrast a Royal Commission

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<sup>5</sup> OECD Economic Surveys: New Zealand 2011 (2011, OECD Publishing).

<sup>6</sup> Paul Kenny "Capital Gains Taxation for New Zealand: Fairer and More Efficient" (2001) 7 NZJTL 265 at 265.

<sup>7</sup> Land and Income Tax Assessment Act 1891.

<sup>8</sup> Paul Kenny above n 6, at 265.

<sup>9</sup> New Zealand Taxation Review Committee *Taxation in New Zealand: Report of the Taxation Review Committee* (Government Printer, Wellington, 1967) at 409.

on Social Policy strongly argued for CGT as it would make New Zealand a fairer society and improve economic efficiency.<sup>10</sup>

## **What We Currently Have in New Zealand (Positivist View)**

By and large, capital gains in New Zealand are not income for the purposes of the Income Tax Act 2007. Over the years, we have moved more towards a Haig-Simons notion of income by incorporating some unrealised gains, as well as the results of past transactions, as income. As a result, New Zealand now has a partial capital gains tax system as capital from specific sources is taxed and others not. For example, certain types of property transactions are taxed, and others not.

Even though income tax is imposed on income (revenue) and not capital (as above), there are a number of provisions in the Income Tax Act 2007 (“the Act”) which are designed to tax capital gains. Thus, as in the case of *Eisner v Macomber*<sup>11</sup>, the tree becomes taxable along with the fruit. For example, sections CB3 to CB5 of the Income Tax Act 2007, tax certain gains derived from the sale of personal property. Further, sections CB 6 to CB 23 of the Act have the effect of bringing certain capital gains on land transactions into the tax net.<sup>12</sup>

In effect, New Zealand has a hybrid tax system in which some gains are excluded from income, some are taxed as they accrue (i.e. fair dividend rate method) and others are only taxed when the asset is sold.

Such a hybrid system is difficult for taxpayers to follow and misleading for foreign investors into New Zealand. Currently, two taxpayers who derive the same amount of

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<sup>10</sup> Ibid.

<sup>11</sup> *Eisner v Macomber* 252 US 189 (1919).

<sup>12</sup> Income Tax Act 2007. (ITA)

income will be taxed on that income differently depending on how that income was derived. For example, an individual who sells his/her house for a profit will likely not be taxed on the capital profit provided the person is not a builder, developer or purchased the house with the purpose of disposal. In contrast, another taxpayer who earns the same amount by virtue of employment must pay tax by way of the PAYE system.

## **Legal Issues Due to a Lack of a Comprehensive CGT**

The untaxed nature of capital gains provides investors with a very strong incentive to try to convert otherwise taxable income into non-taxed capital gains.<sup>13</sup>

As mentioned above, New Zealand income tax is a tax on income (revenue) not capital receipts. Therefore, when dealing with income, we quite often have to deal with the difference between capital and revenue receipts. The distinction of capital versus revenue is argued using the principles established in tax cases such as *Eisener v Macomber*, *BP Australia v FCT* and *CIR v Wattie*.<sup>14</sup>

The case of *BP Australia v FCT* laid down key principles that one may apply when determining whether an expense/receipt is capital or revenue in nature. This case recognized the following tests in this regard:

1. Whether or not the expense gives rise to an enduring benefit. If so, may indicate capital;

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<sup>13</sup> Victoria University of Wellington Tax Working Group *A tax system for New Zealand's future: report of the Victoria University of Wellington Tax Working Group, Wellington, N.Z* (Centre for Accounting, Governance and Taxation Research, Victoria University of Wellington, 2010). (TWG)

<sup>14</sup> *Eisner v Macomber* 252 US 189 (1919), *Commissioner of Inland Revenue v Wattie* (1998) 18 NZTC 13,991 (PC) and *BP Australia Ltd v Federal Commissioner of Taxation* (1965) 112 CLR 387.

2. Whether the expense is used to alter the structure of the business. If so, may indicate capital;
3. Identify what is the nature of the asset or advantage gained (linked to enduring benefit);
4. Whether the payment is from fixed or circulating capital. If the payment is from fixed capital, this may indicate capital expenditure; and
5. One-off or recurring payment? If it is an extraordinary payment, may indicate capital.

Note that the above tests relate to deductions but can be equally applied to income:

### **Ill-defined Boundary (Uncertainty)**

In the case of *BP Australia Limited v FCT*, the Privy Council noted that the distinction between capital and revenue receipts is sometimes difficult to draw and requires distinctions of some subtlety to be drawn between profit that is made “out of” assets and profit that is made “upon” assets or “with” assets.

Due to the uncertainty that often exists as to whether a particular gain is taxable, artificial boundaries are required between what is taxable and what is not taxable.

### **Income – an Undefined Concept**

A taxpayer who derives a receipt which falls within the concept of “income accordingly to ordinary concepts” must include that amount in their taxable income.<sup>15</sup> It should be noted however that there is no comprehensive statutory definition of this

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<sup>15</sup> ITA 2007, above n 12, s CA1(2).

concept in the Act. Over the years, many theorists have tried to ascertain the exact meaning of such a concept taking views from an economic, accounting and judicial perspective.<sup>16</sup>

From an economic perspective, income is traditionally described in terms of an increase in economic wealth (e.g. the increase in the value of assets measured between two points of time). If this view prevailed, it would lead to the taxation of all unrealised and realised capital gains, the taxation of imputed income (e.g. the benefit of owning a house and receiving rental income) and the taxation of all gifts and windfall gains.<sup>17</sup>

Unlike the economic perspective, the accountants approach is one of transactions in that revenue is measured only when it occurs. That is, this approach does not involve any evaluation of the increase in the value of assets between two points in time.<sup>18</sup>

The principle established in *A Taxpayer v CIR*,<sup>19</sup> income is defined as a gain derived from property which leaves the property intact. Common analogies referred to in cases such as *Eisner v Macomber*<sup>20</sup> are the fruit of the tree (i.e. dividends) as distinct from the tree (i.e. shares), and the crop as distinct from the land.

Victor Thuronyi,<sup>21</sup> emphasised that the manner in which income is defined can make a big difference and it is very important to define the concept of income with some precision and predictability. To arrive at an understanding of what exactly taxable

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<sup>16</sup> *Looking Ahead to a Capital Gains Tax in New Zealand* (Commerce Clearing House New Zealand, Auckland, 1988).

<sup>17</sup> Ibid.

<sup>18</sup> Ibid.

<sup>19</sup> *A Taxpayer v Commissioner of Inland Revenue* (1997) 18 NZTC 13,350 (CA).

<sup>20</sup> *Eisner v Macomber* above n 11.

<sup>21</sup> Victor Thuronyi "The Concept of Income" (1990) 46 Tax L Rev 45.

income is, it is first necessary to ask what the concept is all about, and what criteria should be taken into consideration when deciding what should be included in the tax net.

## Henry-Simons (Haig-Simons), Adam Smith and the Concepts of a Comprehensive Tax Base (Normative)

The idea of a comprehensive tax base can be traced back many years. Robert Haig and Henry Simons were two American economists who refined the concept of income originally advocated by a German scholar, Georg von Schanz.<sup>22</sup> Henry Simons argued that personal tax in a contemporary system should be based on an economic definition. That is, according to Simons, income should total an individual's consumption and change in net worth during a particular time period. This concept of income includes *all* sources.

In Simons' 1938 work,<sup>23</sup> he qualifies in the so-called Haig-Simons model that taxable income may be defined as the algebraic sum of the market value of a person's assets and the change in the value of those assets between the beginning and end of the taxable period in question. This means that income should be described (or defined) as the sum of accumulation (the change in the taxpayer's wealth) from one taxable period to the next. From this flows the idea that annual increments in economic power (being capital gains) should be subject to tax.

Essentially, it appears Simons is saying income should fall within the economic or accounting equation of income. That is, Simons' definition of taxable income is as follows;

$$R = \text{Assets (including realised gains)} - \text{Liabilities} + \text{Revenue gains from assets} - \text{Expenses (incurred by virtue of the assets and liabilities and any realised capital losses).}$$

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<sup>22</sup> Rick Krever and Neil Brooks, *A Capital Gains Tax for New Zealand* (Victoria University Press, Wellington, 1990) at 43.

<sup>23</sup> Henry C Simons, above n 1.



The above equation falls within an economic and accounting concept of income and Simons argues this the best form of taxation. Rather than have capital gain “exemptions”, Simons argues that if we approach a comprehensive tax base in this systemic way, the system becomes much clearer and equitable for taxpayers.

The above concept can also be linked to Adam Smith<sup>24</sup> who, in 1778 identified two types of equity:

1. Horizontal equity: The idea that individuals with similar economic circumstances should be treated equally. That is, taxpayers who have an equal ability to pay should bear equal burdens of tax.
2. Vertical equity: here the argument runs that the majority of individuals who realise capital gains are in the higher marginal tax bracket and to exempt capital gains is to favour those taxpayers.

From the above, the Haig-Simons definition of income appears to be the best operational index of equality.<sup>25</sup>

Adam Smith also identified that an efficient tax system is one where investment is channelled towards avenues which give it the best profitability based on market returns rather than tax-favoured areas. A comprehensive capital gains tax would promote growth in that it would reduce property related savings which might increase savings available to be invested in productive New Zealand businesses.

Taxes for assessment and collection should be convenient for the government and also for the person paying the tax to limit the costs of the government administering the tax system and to taxpayers complying with it. This is most readily achieved by a tax system which for most taxpayers is as simple as possible. That is, the economic

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<sup>24</sup> Adam Smith, *Wealth of Nations* (Everyman’s Library, London, 1991).

<sup>25</sup> 25 Rick Krever and Neil Brooks, above n 22 at 43.

efficiency of a tax system is enhanced if the participants in a transaction are able to determine in advance, with certainty the tax liability created by a particular transaction. It can be argued that a comprehensive capital gains tax creates this certainty.

Adam Smith argues that any tax system should be certain. Uncertainty encourages people to avoid tax which leads to disputes with the Inland Revenue. Reforms to the taxation of income from capital can reduce the complexity of the existing tax system by removing ambiguous distinctions between taxed and untaxed income.

## **Part 2: Taxable Capital Gains**

### **Introduction**

Income from property is the clearest example of the common law concept of a flow derived from source, the source being the underlying property itself. Generally, the source of income is the profit-yielding subject, structure or organisation and is of a capital nature (e.g. It yields income and remains intact).<sup>26</sup>

Although income tax is on income (revenue) and not capital, there are a number of provisions in the Act which are designed to nullify this distinction. That is, the tree becomes taxable along with the fruit. Specifically, certain capital gains derived from the sale of personal property<sup>27</sup> and also those arising from land transactions<sup>28</sup> are effectively carved out of the legislation and taxed accordingly.

### **The Ways in Which Capital Gains can be Taxed**

There are essentially two ways in which capital gains can be taxed. Firstly, capital gains can be taxed on a realisation basis when the asset is sold. Secondly, on an accrual basis where a capital gains tax is incurred on an annual basis regardless of whether the taxpayer has retained or sold. Following on from Haig-Simons definition of income, Burman and White<sup>29</sup> conclude that it would also be beneficial for New Zealand to introduce a realisation-based capital gains tax.

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<sup>26</sup> 26 *New Zealand Master Tax Guide for Students* (CCH, Auckland, 2009).

<sup>27</sup> 27 ITA 2007, above n 12, ss CB3- CB5.

<sup>28</sup> Ibid, ss CB6 - CB23.

<sup>29</sup> Leonard Burman and David White "Taxing Capital Gains in New Zealand" (2003) 9 NZTLP 355.

One difficulty with using the realisation method is that there would need to be a regulatory body to administer property ownership details. The absence of an efficient regulatory body to do this would impose extreme difficulties in administering the taxing of capital gains. Other jurisdictions face the same issue but in many cases simply allocate a particular sector of the Inland Revenue to deal with capital gains.

Even if the regulation of property ownership is resolved, there will still be a timing issue associated with realisation.

Most taxpayers would prefer the realisation method because then they will be taxed on actual gains but the downside to this is that it places a huge tax burden on the taxpayer at a point in time (when the taxpayers ultimately sell their asset). From a tax simplicity point of view the tax system would be simplified using the accrual basis as opposed to the realisation method because there would be less complex legislation using this method.

The accrual method would operate similar to that of the Fair Dividend Rate (FDR). The FDR is a method for calculating income or loss from an interest in a foreign investment fund. Effectively, this is a regime in that investors would simply pay a flat or fixed percentage each year on the “market value” of the asset. In times of a reduction in prices due to outside influences such as a downturn in the economy or a natural disaster (such as the recent Christchurch earthquake), the accrual percentage and tax would be calculated with reference to the deflated value (as occurs under the FDR method of taxation).

## Gains From the Sale of Personal Property

Gains arising from the sale of property where the taxpayer is a dealer in such property are taxable.<sup>30</sup> Likewise, gains arising from a profit making undertaking or scheme are also made taxable under the Act.<sup>31</sup>

Furthermore, gains arising from the sale of property acquired for the *purpose* of sale are also taxable.<sup>32</sup> That is, shares acquired for their dividend yield give rise to untaxed gains, while those acquired for their capital yield generally do not. Both the New Zealand and Australian authorities take the view that *purpose* in this context is the *purpose* of the taxpayer (ie. they adopt a subjective test). Hutchison J stated in *Davis v CIR*<sup>33</sup> that “...what we are concerned with is the state of mind of the appellant when he acquired the property”. Similarly, Fullager J in *Pascoe v F.C.T.*<sup>34</sup> referred to a taxpayer’s “purpose or object” or “other state of mind” of which “the statements of that person in the witness box provide, in a sense the „best“ evidence, but for obvious reasons they must... be tested most closely and received with the greatest caution”.

Such a subjective approach usually involves costly and time consuming litigation in which taxpayers are investigated as to their actual purpose or intention. It results in “hair-splitting decisions” that are of little use as precedents because each case depends on its own unique facts. Furthermore, it encourages taxpayers to be dishonest – to express a purpose which will not incur tax liability whether or not that purpose is true.<sup>35</sup> That is, the subjective purpose test is viewed through an objective lens by the court.

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<sup>30</sup> ITA 2007, above n 12, s CB5.

<sup>31</sup> Ibid, s CB3.

<sup>32</sup> Ibid, s CB4.

<sup>33</sup> *Davis v Commissioner of Inland Revenue* [1959] NZLR 635 (SC).

<sup>34</sup> *Pascoe v Federal Commissioner of Taxation* (1956) 11 ATD 108.

<sup>35</sup> Such deficiencies are well illustrated in *Steinberg v Federal Commissioner of Taxation* (1975) 134 CLR 640.

Taxpayers who speculate, deal in property or carry out an undertaking or scheme for profit essentially have their transactions carved out by legislation and caught under specific taxing provisions of the Act. In my view, introducing a comprehensive CGT may result in “overkill” and act to “hurt” the wrong taxpayers (e.g. those taxpayers who purchase property merely with a vague hope that such property will increase in value).

## **Gains From the Sale of Land**

The Act has detailed and complex provisions bringing many gains on land transactions into the tax net. In broad terms, the Act taxes gains on the sale of land acquired with an intention of resale, gains made by land dealers, developers and builders and gains arising from the rezoning, subdivision or development of land.<sup>36</sup>

There are various exemptions available for a taxpayer’s private residence, business premises, farmland and where a taxpayer carries out an undertaking or scheme merely for the purpose of deriving land income prior to disposal.<sup>37</sup> Effectively, the Act carves out certain transactions and taxes taxpayers on certain capital gain made on disposal.

Accordingly, in spite of claims that New Zealand does not have a comprehensive CGT, many types of capital gains are in fact taxed as ordinary assessable income.

## **Capital Versus Revenue - Ill-defined Boundary**

As the Privy Council noted in *BP Australia Limited v FCT*,<sup>38</sup> the distinction is sometimes difficult to draw between profit that is made “out of” assets and profit that is made “upon” assets.

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<sup>36</sup> ITA 2007, above n 12, ss CB6 – CB14.

<sup>37</sup> Ibid, ss CB16 – CB23.

<sup>38</sup> *BP Australia Ltd v Commissioner of Taxation of the Commonwealth of Australia* [1966] AC 224 (PC).

Lord Pearce in *BP Australia Ltd v C of T*<sup>39</sup> noted one guide to ascertaining whether a receipt is on capital or revenue account is to consider whether the transaction gives rise to fixed or circulating capital. “Fixed capital is prima facie that on which you look to get a return by your trading operation. Circulating capital is that which comes back in your trading operations”.<sup>40</sup>

Three seminal cases which have subsequently interpreted the meaning of capital as discussed were *BP Australia Ltd v C of T*<sup>41</sup>, *C of IR v McKenzie*<sup>42</sup> and *C of IR v Wattie*<sup>43</sup> where a number of other key factors were weighed by the Judicial Committees:

1. The need or occasion which called for the expenditure
2. Whether the payments were of a once-and-for-all nature, producing assets or advantages having an enduring benefit
3. How the receipt would be treated under ordinary principles of commercial accounting

Thus, “artificial boundaries” have essentially been created and are required to be considered in determining the taxable nature of a transaction. The lack of a comprehensive CGT in New Zealand has led to many tax disputes between taxpayers and Inland Revenue. For example, inducement payments are a key example of where New Zealand’s artificial capital/revenue boundaries create uncertainty for taxpayers.

In *Birkdale Service Station Ltd v C of IR*,<sup>44</sup> the Court of Appeal affirmed the High Court’s decision that one-off inducement payments made to service station proprietors

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<sup>39</sup> *BP Australia Ltd v FCT*, above n 3.

<sup>40</sup> *Ibid*, at [265] per Lord Pearce.

<sup>41</sup> *BP Australia Ltd v Commissioner of Taxation of the Commonwealth of Australia* [1966] AC 224 (PC).

<sup>42</sup> *Commissioner of Inland Revenue v McKenzies New Zealand Ltd* (1988) 10 NZTC 5,233 (CA).

<sup>43</sup> *Commissioner of Inland Revenue v Wattie* (1998) 18 NZTC 13,991 (PC).

<sup>44</sup> *Birkdale Service Station Ltd v Commissioner of Inland Revenue* (1999) 19 NZTC 15,493 (HC) and *Birkdale Service Station Ltd v Commissioner of Inland Revenue* (2000) 19 NZTC 15,981 (CA).

to sell Mobil products exclusively were revenue in nature. This was on the basis that the taxpayers did not give up any part of their business or change the structural nature of their business in exchange for the inducement. One of the taxpayers in this case however, Kenlock Motors Ltd had an agreement with Mobil involving a lease and sublease of its service station property which had a term of 15 years. Because of the long term nature of the agreement and the fact that the Kenlock Motors Ltd used the funds to change the structural nature of their business, this payment was held to be capital in nature and thus non-taxable.<sup>45</sup>

The *Birkdale Service Station* case illustrates that there is significant controversy surrounding the artificial capital/revenue boundaries which, in turn, has created much uncertainty for taxpayers and introducing a comprehensive CGT would eliminate such uncertainty and ensure the nature of a transaction is easily defined.

## **Rental Properties**

The lack of a comprehensive CGT in New Zealand may have encouraged New Zealanders to invest heavily in real property, especially housing thus significantly driving up house prices. Housing represents approximately 70% of total net assets for New Zealand households, whereas it represents only about 30% of US total net assets.<sup>46</sup> Not taxing capital gains arising upon the sale of rental property unless a specific provision deems otherwise, has in effect created a one sided benefit to taxpayers. For example, taxpayers with a rental property are essentially allowed to utilise tax losses arising from ownership of the property yet in many cases don't pay tax on the ultimate gain when the property is sold. Introducing a comprehensive CGT may act to counteract this arbitrage tax advantage.

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<sup>45</sup> *BP Australia Ltd v FCT*, above n 3.

<sup>46</sup> Robin Oliver, "Capital Gains Tax – the New Zealand Case" (paper prepared for the Fraser Institute 2000 Symposium, on Capital Gains Taxation, September 18, 2000) <[www.fraserinstitute.org](http://www.fraserinstitute.org)>.



## **The “Lock-in” Effect of a Capital Gains Tax**

The introduction of a comprehensive CGT in New Zealand would possibly encourage taxpayers to hold on to their capital assets in an attempt to postpone their CGT liability.<sup>47</sup> This phenomenon, also referred to as the “lock-in” effect could possibly lead to a further increase in the fluctuation of property such as shares and land. Various incentives however could act to counteract this “lock-in” phenomenon. For example, if all gains from property are to be taxable, there could be an exemption in place whereby to the extent to which proceeds from the sale of the property are reinvested in other investment property, no capital gains tax arises as occurs in other countries such as Australia and the United Kingdom.

## **Fairer Tax System – Direct Versus Indirect Investment**

Many structural problems are created by the capital/revenue boundary in New Zealand. This can be best illustrated by the inconsistent tax rules in the savings area when a taxpayer wishes to invest in shares. This can be done directly or through an intermediary such as a fund. The lack of a general CGT has resulted in a series of rules that generally encourage direct over indirect investment.

For example, when a company distributes to its shareholders a capital gain, no tax credit is available because no company tax has been paid on such capital gain. Thus, such capital gain exemption provided at the company level is clawed back when the gain is distributed to shareholders as a dividend. Taxing all capital gains would act some way towards creating fairness in tax treatment of direct and indirect investment.<sup>48</sup> To some extent, this has been achieved by the introduction of the Portfolio Investment Entity regime, which allows for certain flow through of capital gains.

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<sup>47</sup> Leonard Burman and David White “Taxing Capital Gains in New Zealand: Assessment and Recommendations” (paper presented to Business Links Seminar 17 September 2009) <[www.victoria.ac.nz/sacl/cagtr/business-links.aspx](http://www.victoria.ac.nz/sacl/cagtr/business-links.aspx)>.

<sup>48</sup> Rick Krever and Neil Brooks *A Capital Gains Tax for New Zealand*, above n 22.

Furthermore, the common law rule that profits from the sale of shares held in a managed portfolio are taxable as ordinary business income has the same disintermediation incentive. That is, it is very difficult for intermediaries to make capital gains even if they can distribute the profits “tax-free. The effect of the rule seems to be to give a tax break to portfolios that are not properly managed (i.e. creates an incentive for passive funds over those that are actively managed).

In April 2007, the Government decided to align the rules for taxing certain capital gains arising from the sale of shares by individuals through the introduction of the Portfolio Investment Entity regime.<sup>49</sup>

## **The Choice of Transaction**

Given that capital gains are not generally taxed in New Zealand means that taxpayers seek to obtain capital rather than income gains and thus this has influence on the form of transactions entered into by taxpayers. For example, the holder of a capital asset such as a patent for a particular product may seek to exploit the asset by selling the asset, in whole or in part for a lump sum. Introducing a comprehensive CGT would encourage taxpayers to seek more revenue (assessable) income and would in-turn increase the Governments tax take.<sup>50</sup>

## **Hedge Against Inflation**

One of the strongest arguments in favour of taxing capital gains is that they are so like income (or other income) that they should be treated as such for tax purposes. Only then, it is said will our tax system accurately reflect differences in the ability to pay of

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<sup>49</sup> Leonard Burman and David White “Taxing Capital Gains in New Zealand”, above n 29.

<sup>50</sup> *Looking Ahead to a Capital Gains Tax in New Zealand*, above n 16.

different taxpayers. This argument relies on the assumption that capital gains can be equated with income (or other income).

However, it is frequently argued that capital gains, in whole or part, merely reflect a hedge against inflation and for that reason should not be taxed or should be the subject of special treatment. That is, it is argued that only “real gains” should be taxed.<sup>51</sup> For example, an asset acquired three years ago for \$500,000 may today have a resale price of \$546,364 – a gain of \$46,364. But if in those three years there was a general increase in the price level of 3% per annum, the gain would appear to be illusory. If the owner of the asset spent the \$46,364 on consumption, he would, in terms of real value, finish up with less capital and less income. Of course, this is a simplified example and in ascertaining whether or not there has been a real gain or loss, a number of other factors must be taken into account.

Under current legislation, tax would not necessarily arise when the purpose of acquiring property (e.g. shares) was to obtain assessable income (e.g. dividends). However, if taxpayers purchase property that does not produce assessable income (e.g. gold); the proceeds from selling such property should generally be taxable as it appears they acquired the property with the dominant purpose of resale.<sup>52</sup> Yet, New Zealand’s tax system fails to cater for such an arbitrage tax outcome.<sup>53</sup> As was seen in *National Distributors v CIR*<sup>54</sup> purchasing property which does not produce assessable income but simply acts as a hedge against inflation may be held to be income for tax purposes.

Therefore, a comprehensive CGT should apply only to those gains which reflect a real increase in wealth. It is therefore essential that we are able to distinguish these “real” gains from other so called capital gains.

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<sup>51</sup> Ibid.

<sup>52</sup> *Commissioner of Inland Revenue v National Distributors Ltd* (1989) 11 NZTC 6,346.

<sup>53</sup> Robin Oliver, above n 46.

<sup>54</sup> *Commissioner of Inland Revenue v National Distributors Ltd*, above n 52.

## Possible Exemptions

Certain exemptions may be justified for items of personal use, such as motor vehicles and household furniture on the basis that they will generally depreciate in value rather than appreciate over time. That is, assets would invariably be in a loss situation if capital gains tax provisions were applicable.<sup>55</sup> For those few items such as antique furniture and jewellery that may appreciate, the problems in determining the cost of assets which may have been purchased many years before ultimate disposition would often be extremely difficult.<sup>56</sup>

Further, the most significant exemption permitted should be a taxpayer's principal residence. In New Zealand, we tend to have a strong "do it yourself" ethos whereby taxpayers tend to improve their properties by doing their own renovations which has the effect of boosting the value of their properties and lifestyle. Such hard work should be valued and not taxed. However, this exemption may prove inequitable because it may encourage taxpayers with the capacity to invest in extravagant dwellings and to divert funds which might otherwise be directed to income-producing activities. The counter argument to this of course is that a capital gains tax on a residential dwelling would be inequitable for the majority of New Zealanders who do not live in extravagant dwellings.<sup>57</sup>

Other exemptions should be made for certain classes of taxpayers, such as those persons, funds or institutions that are at present exempt from ordinary tax. Some other further exemptions might be made for such items as gambling winnings or assets used to produce exempt income.

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<sup>55</sup> *Looking Ahead to a Capital Gains Tax in New Zealand*, above n 16.

<sup>56</sup> *Ibid.*

<sup>57</sup> *Looking Ahead to a Capital Gains Tax in New Zealand*, above n 16 and also *Pacific Rendezvous Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 567 (CA).

## **“Small” Gains**

To reduce administration, it is also necessary to have some provisions for exempting small gains from tax. Alternatively, we could introduce a de minimis principle similar to that of the Fair Dividend Rate (FDR) regime whereby capital gains up to a certain monetary value would be exempted from such a tax.

## **Losses for Tax Purposes**

If all realised gains are to be brought into the tax base, equity requires that all realised losses should be applied to reduce the tax base. Therefore, I recommend that losses realised from dealings in property should be deductible in full from all other forms of income. Although this proposal may prove expensive to tax revenues in years of declining asset values, I feel that not only would it result in a tax base that would be a better reflection of taxable capacity, but that it should provide an incentive for risk investment.

## **Treatment of Capital Losses**

If capital gains are to be taxed, capital losses should be deductible in some form. Generally, such losses should be able to be deductible in full from other forms of income. Given the current economic environment which has resulted in a significant decline of asset values, implementing a general CGT at this time may prove costly to New Zealand’s tax revenue.<sup>58</sup> Another issue arises in the fact that taxpayers would be encouraged to realise their capital losses, but not their capital gains. Allowing capital losses to be deductible however will act as an incentive for risk investment.

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<sup>58</sup> TVNZ One News “Manufacturers looking for 1% cut to OCR” (11 March 2009) <<http://tvnz.co.nz/business-news/manufacturers-looking-1-cut-in-ocr-2533410>> .

## Difficulty in Implementation

Section 6A of the Tax Administration Act 1994 charges the Commissioner of Inland Revenue to collect over time the highest net revenue having regard to the resources available.<sup>59</sup> Introducing a capital gains tax based on realisation have raised a number of concerns. In my view, a comprehensive CGT can be very complex and expensive to administer. Experience in most countries suggests that definitional problems and questions about valuation lead to considerable litigation and dispute. This is further complicated by the existence in most CGT regimes of exemptions, roll-over relief, thresholds and different rates of tax.<sup>60</sup> Some claim the costs of administering such a tax will be as high as administering New Zealand's transfer pricing regime.<sup>61</sup> Further, the Inland Revenue argues that such a tax would be challenging to administer.

Within New Zealand, a good amount of time and effort is spent on monitoring the capital versus revenue boundary.

If capital gains were fully taxable, the boundary between revenue and capital receipts would be irrelevant as the tax consequences would not change. The capital versus revenue boundary would still matter if capital gains were taxed at a low rate, but there would be little incentive for taxpayers to artificially classify transactions as capital.

A comprehensive CGT may not be simple to comply with, although it is not particularly difficult for listed shares and unit trusts. If compliance burdens are of serious concern, then small capital gains could be exempted from income tax. For taxpayers with substantial investment income, the current regime is arguably more complex than the new one because the boundary between capital and revenue is so idiosyncratic. A

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<sup>59</sup> Tax Administration Act 1994.

<sup>60</sup> *Capital Gains: Should New Zealand Tax Them?* (CoACT, Wellington, 1989).

<sup>61</sup> Rick Krever and Neil Brooks *A Capital Gains Tax for New Zealand*, above n 22.

rational and consistent definition of capital gain could be easier for taxpayers to understand and comply with.<sup>62</sup>

## **The Need for Transitional Measures**

If a comprehensive CGT was introduced into New Zealand, it would probably not be retrospective. That is, the tax would only be applicable to gains that accrue after a nominated date.<sup>63</sup> Therefore, unless New Zealand adopts provisions as generous as those set in Australia which only bring into tax disposals of assets acquired after the implementation date, various transitional provisions would be required to govern the taxation of gains and losses arising from the disposal of property owned at the effective date of the commencement of the tax.

In my view, New Zealand's current tax system is too complicated as it currently stands making it difficult for taxpayers to comply with the system and also creating a non-friendly business environment. Robin Oliver argues that simplicity has not been the outcome of a lack of capital gains tax in New Zealand.<sup>64</sup>

## **Distorted Savings**

New Zealand's saving system and its long-term economic future have been distorted for too long by the lack of a fair and broad capital gains tax regime. For years, many have cautioned against our addiction to property investment at the expense of investment in other more productive and diversified assets. In addition, many New Zealanders have

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<sup>62</sup> Daniel Hunt, "Looking Ahead to a General Capital Gains Tax in New Zealand" (paper prepared for the Concepts of Income, Allowable Deductions and Capital Gains Taxation course, AUT University, 19 March 2009).

<sup>63</sup> Clinton Alley and others, *New Zealand Taxation 2008: Principles, Cases and Questions*, (Thompson Brookers, Wellington, 2008).

<sup>64</sup> Robin Oliver, above n 46.

invested in finance companies such as Bridgecorp and Hanover Finance on the promise of high returns and capital growth which has not eventuated and resulted in significant losses of capital upon collapse of the companies.

New Zealanders have borrowed up large from overseas investors which, in turn has fed a binge on borrowing based on the increase equity in homes and other non-productive assets. New Zealanders have done this in the belief that continued borrowing will lead to higher prices, which in turn creates huge capital gains that are not taxed.<sup>65</sup>

In saying that, a key question facing New Zealand is whether introducing a comprehensive CGT regime will discourage investment here, and encourage New Zealand residents to invest abroad.<sup>66</sup>

Whatever form a comprehensive CGT may take, overall savings rates and the incentive to accumulate lifetime wealth will be harmed. New Zealand's economy needs just the opposite to improve investment and job creation opportunities. There is strong evidence that younger people have a lower propensity to save than their elders in the workforce and there is an increasing proportion of retired people whose propensity to save is lower still, if not negative.

## **CGT May Double Tax Savings**

Under an income tax, income that is saved gets taxed twice – when first earned and then as tax on the returns to savings (e.g., interest, dividends etc). In addition, the money will be taxed again under GST when it is spent. In contrast, income that is spent immediately is taxed only twice – as initial income and when it is spent.

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<sup>65</sup> "Impose a Fair Capital Gains Tax" *The Independent Financial Review* (New Zealand, July 5 2006) 14.

<sup>66</sup> *Capital Gains: Should New Zealand Tax Them?* above n 60.



Furthermore, taxing capital gains on assets used as a savings vehicle may also become taxable. For this reason, national savings are likely to be enhanced by not having a capital gains tax. Overall however, capital gain assets may incur a lower effective tax rate than assets that pay returns in taxable forms such as interest, rents, and royalties.

Under the traditional income tax system, corporate profits are taxed once at the company level and again at the shareholder level. In New Zealand, this is not so much of a problem because of the imputation of tax credits to shareholders against tax paid at the company level thus offsetting the double tax.

### **Reduced Entrepreneurship, Risk Taking and Business Formation**

The introduction of a comprehensive CGT in New Zealand will, in my view, significantly affect entrepreneurship and new business start-ups. A significant portion of money to start new businesses comes from taxable individuals. For such individuals, whether gains are taxed significantly influences their investment decision.

The traditional argument for a CGT has been that entrepreneurs build up a business and make a capital gain and avoid tax on the disposal. If a comprehensive CGT was to be introduced into New Zealand, it could lead to decreased formation of new businesses because individuals are less willing to undertake the risk associated with start-ups.<sup>67</sup>

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<sup>67</sup> Paul Singleton, above n 2.

## **Part 3: How Should Capital Gains be Taxed?**

### **Introduction**

The issue of whether to account for capital gains annually as they accrue or when they are realised is a fundamental one.

It would be prudent to suggest that New Zealand should tax capital gains as ordinary income as they accrue, not when realised (similar to interest payments). This is because the increase in asset value represents an accretion to wealth. This would be the ideal CGT regime. Accrued capital losses could be deductible against other income. However, it is noted that under this way of taxation, the system could be manipulated by taxpayers claiming that they expect certain assets to appreciate (but did not) and therefore claim the accrued capital loss.

It is more equitable to tax capital gains as they accrue on an annual basis. Unrealised capital gains are already being imposed in forms of investment such as Foreign Investment Funds and to tax unrealised capital gains differently would not be equitable.

An accrual basis will make the tax system more neutral in that investment decisions will be based on income earning investments rather than capital appreciation property. This will improve economic efficiency and encourage economic growth.

For logical consistency, my view is that income and expenditure should be indexed for inflation. This would ensure that only the “real” gain or loss is included as income.

## **Problems with the Accrual Basis**

There are essentially two main problems with imposing a CGT on an accrual basis. First, an ability to value assets every year is critical to such a regime. Such yearly valuations will increase the compliance costs of taxpayers. Valuation methods must be established which are easy to comply with, easy to verify and objective in nature. The second issue is that under an accrual-based CGT, taxpayers will be liable to pay tax on the appreciating value of their assets even though the gain has not been realised (similar to the Fair Dividend Rate regime). Certain taxpayers in such a situation may have no cash from which the tax can be paid.

## **Alternative Method to the Accrual Basis**

Alternative to the accrual basis, New Zealand could ensure capital gains as well as other forms of capital income (interest, rents, royalties, and dividends) would be exempt from tax. Under this method, tax would not be distorted by investment decisions.<sup>68</sup>

## **Realisation**

One difficulty with using the realisation method is that there would need to be a regulation body to administer property ownership details. The absence of an efficient regulatory body to do this would impose extreme difficulties in administering the taxing of capital gains.

Even if the regulation of property ownership resolved, there will still be a timing issue of realisation. We currently have this situation in New Zealand in respect of GST and we know how problematic timing issues can be.

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<sup>68</sup> Leonard Burman and David White “Taxing Capital Gains in New Zealand”, above n 29.

Most taxpayers would prefer the realisation method because then you will be taxed on actual gains but the downside to this is that it places a huge tax burden on the taxpayer at a point in time, being realisation. The realisation may increase the equity, efficiency and simplicity of the New Zealand tax system if fashioned properly.

From a tax simplicity point of view the tax system would be simplified using the accrual basis as opposed to the realisation method because there would be less complex legislation using this method.

## **Bunching Issue**

As New Zealand has a progressive income tax system (similar to many countries throughout the world), and the net taxable capital gains are treated as assessable income, a problem in equity arises where the gains – which are often made over many years – are taxed at the taxpayers' top marginal rate in one year.<sup>69</sup> This problem would not exist if capital gains were taxed on the accrual basis, but this leads to the problems set out above.

## **Capital Gains Tax Rate**

In my view, Capital Gains should be taxed at the same rate as ordinary income to assist with the administrative complexity of taxing such gains. That is, if a taxpayer makes a gain of \$100,000 in any one income year, this should simply be added to their total taxable income for that year.

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<sup>69</sup> *Capital Gains: Should New Zealand Tax Them?* above n 60.

## Tax Working Group

In response to the Tax Working Group report on New Zealand's review of the New Zealand tax system, Bill English stated "A more cut-and dried test for when property transactions incur a capital gains tax and the ring-fencing of tax losses from the property sector are options under consideration".<sup>70</sup>

Mr English went on to state:

"...some capital gains were already taxable but the test for which side of the capital/revenue boundary a transaction falls on, and therefore whether it gives rise to taxable income, depends on the slippery issue of the seller's intent when the asset was brought".<sup>71</sup>

There has been significant

"...discussion about whether the intent test in the tax act is well understood and properly administered, and should there be other tests like a bright line test, for instance a two-year test".<sup>72</sup>

This statement followed on from the Prime Minister's announcement that ruled out a "comprehensive" CGT in New Zealand.<sup>73</sup>

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<sup>70</sup> "Govt eyes clearer capital gains tax" (11 February 2010) New Zealand Herald <[www.nzherald.co.nz](http://www.nzherald.co.nz)>.

<sup>71</sup> Ibid.

<sup>72</sup> Ibid.

<sup>73</sup> Ibid.

## **Part 4: Advantages & Disadvantages of a Comprehensive Capital Gains Tax**

### **Introduction**

#### **The Arguments for a CGT**

James Callaghan, the Chancellor of the Exchequer in the introduction to the 1965 United Kingdom Budget stated the following:

“The failure to tax capital gains is widely regarded as the greatest blot on our existing system of direct taxation. There is little dispute nowadays that capital gains confer much the same kind of benefit on the recipient as taxed earnings more hardly won. Yet earnings pay tax in full while capital gains go free. This is unfair to the wage earner.”...“Moreover, there is no doubt that the present immunity from tax of capital gains has given a powerful incentive to the skillful manipulator of which he has taken full advantage to avoid tax by various devices which turn what is really taxable income into tax-free capital gains”.<sup>74</sup>

The above comprise the two aspects of Adam Smith’s first maxim of taxation; that taxes should be equitable and efficiency. Equity is an elusive concept, invoking the notions of fairness, which unavoidably involve value judgments.<sup>75</sup>

### **Equity**

Equity provides a strong argument for a comprehensive CGT. The argument as to horizontal equity may be illustrated by the example of two taxpayers in similar circumstances who receive the same amounts of money comprised, in one case, entirely of ordinary income and, in the other, of both ordinary income and capital gains. An individual who realises a \$10,000 gain on the sale of an asset has the same ability to pay

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<sup>74</sup> (6 April 1965) 710 GBPD HC 245.

<sup>75</sup> Anna Dixon, “Risk-Free Return Method: Out of the Frying Pan and Into the Fire” (2003) 9 NZJTL 329.

– the same ability to consume or to save – as an individual who receives \$10,000 in interest income or who earns \$10,000 as salary or wages. Therefore, not taxing capital gains results in some people paying less tax, compared to other people with the same ability to pay.<sup>76</sup>

Accordingly, the absence of a comprehensive CGT can cause an injustice of the current tax system. Taxpayers who generate profits through capital gains are exempt from tax, whereas taxpayers who generate similar profits but from income flowing sources are taxed. This is the great injustice of the current tax system. The fundamental principle of social justice is that people in comparable circumstance should be treated equally.

Equity with respect to how tax burdens fall on taxpayers is important for acceptance of, and compliance with, the tax system by the community. Given the difficulty in universally defining what is “fair”, two fundamental principles of equity have been developed when considering the “fairness” of the manner in which a tax burden falls. The key principles are horizontal equity and vertical equity.

The tax treatment of capital losses is one of the most significant problems of designing a CGT. In many countries, only restricted relief is provided for losses, which involves limiting the offset of capital losses to capital gains alone. Such a system creates vertical inequity, as diversification of investment is not an option for small investors. As a result, small investors who incur losses are unlikely to have corresponding gains, resulting in non-deductible losses. Contrastingly, taxpayers with the ability to invest in diversified portfolios can almost always apply their capital losses against capital gains. We can solve the above issue by careful design of the tax to ensure that gains and losses are treated appropriately.<sup>77</sup>

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<sup>76</sup> Rick Krever and Neil Brooks, above n 22.

<sup>77</sup> Andrew Alston, *The Taxation of Capital Gains in New Zealand* (LLM Thesis University of Canterbury, 1981).

## **Efficiency**

As discussed above, there is a strong attraction for a comprehensive income tax which would tax accruing gains on assets that appreciate.

However, in practice, no country has a general CGT on accruing gains.<sup>78</sup> If New Zealand were to follow this approach, the issue that would need to be considered is whether or not there would be efficiency benefits from bringing in a “real world” CGT which is likely to involve taxing released capital gains. It may be best to stick with an accrual based concept to taxing capital gains.

Efficiency is the neutrality concerning investment decisions between investments that generate annual financial flows and those that generate capital gains. Efficiency focuses on having as least as possible distortion in the allocation of resources.

## **Allocation of Resources**

In order to ensure efficient allocation of resources and spur economic growth, capital should be encouraged to seek its highest rate of return. If capital gains are not taxed then capital will flow to these assets or sectors of the economy and away from those with higher rates of return. This leads to misallocation of capital. Such distortions impede economic growth thereby lowering living standards. The following economic inefficiencies are as a result of not taxing capital gains:

1. Encourages investors to invest in fewer productive investments and realise profits by investing in non-productive investments;
2. Many assets such as collectible and antiques are unproductive;

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<sup>78</sup> Policy Advice Division of the Inland Revenue Department and New Zealand Treasury “The Taxation of Capital Gains: Background Paper for Session 3 of the Victoria University of Wellington Tax Working Group” (2009) <[www.victoria.ac.nz/sacl/cagtr/twg/](http://www.victoria.ac.nz/sacl/cagtr/twg/)>.



3. Distorts corporate financial policy because shareholders would prefer realizing equity than receiving dividends.

## **Certainty**

Certainty in tax law minimises disputes about the amount of a tax and assists in predictions of the tax yield. The introduction of a comprehensive CGT in New Zealand would allow the capital/revenue distinction to become irrelevant.<sup>79</sup>

Certainty of liability is the ease and accuracy in calculating a CGT liability. While international evidence suggests that CGT can be a complex taxing provision in certain cases, in most cases there is little difficulty in calculating CGT. The implementation of CGT in New Zealand may act to reduce tax avoidance and evasion and increase revenue for the government. Overall, it can be expected that a CGT will improve certainty.

A capital gains tax is generally said to support the integrity of the tax system by reducing opportunities for tax planning and tax avoidance. For instance, a New Zealand company could currently develop some intellectual property and sell it to an offshore associated company for an untaxed capital gain, and then license the intellectual property back and pay a tax deductible royalty. Introducing a CGT in New Zealand would result in there being no tax advantage to this transaction.

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<sup>79</sup> Anna Dixon “Risk-Free Return Method”, above n 75.

## **Simplicity/Convenience**

Simplicity is generally considered in terms of administration costs of the Government and the compliance costs of taxpayers. Simplicity can, theoretically at least, be measured by estimating these costs, known as operating costs, and dividing this amount over the amount of tax revenue.

Many people already view New Zealand's Tax system as complex and consider that the introduction of a CGT would further complicate the tax system. As above, I disagree with this as New Zealand already has a problematic and complex situation in dealing with the capital/revenue distinction.

From experience, the capital versus revenue distinction accounts for the vast majority of tax litigation. This is mainly due to the absence of a comprehensive CGT. The motivation for taxpayers is that they prefer income to be of a capital nature thereby not taxable and expenses in the nature of income and therefore deductible.

With the introduction of a comprehensive CGT, it will reduce one of the greatest uncertainties in New Zealand tax law (capital/revenue), effectively making the tax system simpler.

## **The Arguments Against a CGT**

### **The Physiological Argument**

However economically desirable a comprehensive CGT may be, our government is unlikely to introduce one if it does not have some measure of popular support. Therefore, it is important that that we be aware of public attitudes to capital gains.

## **Compliance Costs**

Under a CGT, New Zealand taxpayers would incur the following compliance costs. They would have to determine their tax liability, pay tax, maintain records, obtain tax advice and undertake capital gains tax planning. The CGT rules in Australia run to over 600 pages of highly technical and complex legislation and a number of Australian commentators have noted that compliance costs are high. The greatest simplification comes from the removal of the income – capital dichotomy. This will effectively end the battle between tax planners and the Government over the elusive concept of what constitutes income.<sup>80</sup>

## **Administrative Costs**

Capital gains taxation will likely create a considerable amount of administration costs for the Government. The New Zealand Inland Revenue will incur costs for tax collection, assessing and auditing, debt recovery, forecasting tax revenue, advising, writing private and public rulings, dispute resolution and litigation.

However, while it is difficult to compare administrative costs internationally, the United Kingdom Inland Revenue's capital gains tax administration costs were only 1.9% of CGT revenue suggesting that New Zealand's CGT administration costs would be similar, and thus minimal compared to the revenue raised.<sup>81</sup> Nevertheless, capital gains tax proves difficult to administer in other countries which have them.

There are often conflicts between the above criteria. Inevitably, one must be traded off against another.

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<sup>80</sup> Paul Kenny "Capital Gains Taxation for New Zealand" above n 6.

<sup>81</sup> Ibid.

## **Part 5: Proposals for Reform in New Zealand**

### **Introduction**

The problems that the lack of a comprehensive CGT poses for New Zealand's income tax system have not gone unnoticed. A number of reviews of the tax system have considered the extent to which New Zealand should tax capital gains (i.e. the McLeod Report & Australia's Henry Report).

### **The McLeod Committee**

The McLeod Committee was in favour of continuing the New Zealand ad hoc approach of dealing with capital gains. The Committee proposed the risk-free return method of taxation as a way to address the problems created by the discrete taxation characteristics of different entities.

The 2001 Tax Review proposed a Risk-Free Return Method ("RFRM") of taxing capital gains. This essentially involves taking the presumptive, rather than the actual, return on qualifying assets. The RFRM has been conceptually approved by the minority Labour-led Government, who have since applied this method to offshore equity investment (vis-à-vis the FDR regime). The RFRM method taxes just the risk-free return – human capital is not taxed at all.<sup>82</sup>

### **Tax Working Group Report**

In May 2009, the Tax Working Group (TWG) was formed by Victoria University, in

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<sup>82</sup> *Tax review 2001: final report* (The Treasury, Wellington, 2001) (known as the McLeod Report).

conjunction with the Treasury and Inland Revenue.<sup>83</sup> The TWG was formed with the endorsement of the Minister of Finance Bill English and the Revenue Minister Peter Dunne. The TWG brought together tax practitioners, academics, business people and officials – those whose job it is to examine and set tax policy, those who deal with its impacts, and those who are watching international developments and research – to see if there was a common understanding of the issues and options for reform.

The TWG had two major tasks: identifying the major issues that Ministers will need to consider in reviewing medium-term tax policy; and better informing public debate on tax.

In January 2010, the TWG released a report outlining their recommendations for Tax Reform in New Zealand. The Government considered these recommendations carefully before delivering the 2010 Budget on 20 May 2010.

The introduction of a comprehensive CGT was canvassed by the TWG.

Specifically, the TWG noted in their report that there are many areas in which New Zealand's tax base is not as broad as in other countries, namely the absence of a comprehensive CGT across all types of income. The group argue that a large component of economic income, capital gains, are not taxed or are taxed in an ad hoc fashion. Further, they noted that this means New Zealand has a lower tax on capital gains, including gains on property, than most other OECD countries. This makes New Zealand unusual amongst OECD countries.

To broaden New Zealand's tax base, the TWG suggested New Zealand introduce a comprehensive CGT. Many members of the TWG considered this a viable option for base-broadening. They argue that in principle, this would make the tax system more efficient by reducing any bias between savings and investment decisions, and more

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<sup>83</sup> Victoria University of Wellington Tax Working Group <[www.victoria.ac.nz/sacl/cagtr/pdf/tax](http://www.victoria.ac.nz/sacl/cagtr/pdf/tax)>.

horizontally equitable by taxing people equally regardless of the nature of their income. Many members counter argued that a comprehensive capital gains tax would result (in some circumstances) in double taxations (i.e. corporate profits). Members of the group were also concerned about the application and administration difficulties of introducing a comprehensive CGT.

Some members favoured accrual capital gains taxation, similar to that of the Fair Dividend Rate contained under the Foreign Investment Fund rules (where investors typically pay 5% on the unrealised value of their overseas share values) which is effectively a CGT in itself.

However, many members of the TWG had significant concerns over the practical challenges and potential distortions and other efficiency implications that may arise from an accrual method of taxing capital gains. The main arguments being that it is not feasible due to such problems as identifying market values for some assets and the cash-flow difficulties that arise when accrued capital gains generate immediate tax liabilities but the assets yield no immediate cash flow returns. The tax working group also cited the administrative difficulties of implementing such as tax and I believe this caused them to discount the recommendation of introducing such a tax also.

## **2010 Budget**

Bill English announced the 2010 Budget on 20 May 2010 which had a strong tax focus. Prior to the budget, the Treasury pushed hard for a CGT on property investments and shares. However, the introduction of such a capital gains tax had been discounted prior to the 2010 Budget announcement on the basis that other tax reforms would be enacted. The introduction of a CGT has been talked about for a long time and no/little action has been taken by Governments in the past. It appears the introduction of a CGT has been discounted by Governments as too controversial and politically unsafe.

## Situations of CGT in Other Countries

As above, in spite of claims that New Zealand does not have a general CGT, many types of capital gains are in fact taxed as ordinary assessable income, which therefore places New Zealand in the category of countries described as having a CGT regime. Different countries have positioned themselves at different points along a spectrum from fully untaxed to fully-taxed. New Zealand however is towards the untaxed end of the spectrum whereby only certain capital gains are taxed.<sup>84</sup>

As above, New Zealand is one of the few countries in the OECD that does not impose tax on capital gains. In the United States, realised capital gains of individuals have been taxed since the Government first taxed income in 1913. The United Kingdom and Portugal introduced taxes on capital gains in 1965. Canada and France introduced a CGT in the early 1970's and Luxemburg in 1979. Australia introduced a tax on capital gains in 1985.

Furthermore, no country, once having enacted a comprehensive CGT, has abolished it.<sup>85</sup> Most countries however have various exclusions and exemptions which apply to certain capital gains. Countries that have attempted to introduce a complete system have all done so on a very comprehensive basis. As a result, the legislation is very long and complex and, most likely, the systems are administratively difficult. Although these three legislative schemes all take different forms, they seem to concentrate on the same matters. That is, they all provide for rates calculated on a different basis from income tax rates, capital losses, special treatment of owner-occupied residences and various exemptions and exclusions (although these differ considerably).

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<sup>84</sup> Andrew Alston "The Taxation of Capital Gains in New Zealand above n 77.

<sup>85</sup> Rick Krever and Neil Brooks *A Capital Gains Tax for New Zealand*, above n 22.

## **Part 6: Conclusion**

This paper has investigated and explored whether or not a comprehensive CGT should be introduced into New Zealand, looking in depth at whether a CGT should be introduced on an accrual or realisation basis. It has considered and critically analysed the extent to which New Zealand currently taxes capital gains and has compared this with other OECD countries that have a CGT regime in place. This paper has also defined the concept of income from a legal, economic and accounting perspective and considered the proposals put forward by the TWG.

To a large extent, many capital gains are already taxed in New Zealand by way of specific provisions of the Act such as gains arising from the sale of personal property and those arising from the sale of land.

However, the ill-defined capital boundary, determined only by reference to artificial principles has provided many opportunities for taxpayers and many problems for the Inland Revenue. Many argue that the absence of a general CGT may have encouraged New Zealanders to invest heavily in housing and direct investment thus significantly driving up house prices.

Although there is still substantial uncertainty as to whether or not gains should be treated as capital or revenue in nature, the specific provisions of the Act effectively carve out obvious intentions of taxpayers to make a profit. Therefore, what results is an equitable and fair outcome for taxpayers on the whole.

In line with the general international trend towards comprehensive income tax bases the case for a CGT in New Zealand is, in my view very strong. In countries such as the United Kingdom, the United States of America and Canada, which have introduced comprehensive CGT systems, the legislation is long and complex and the systems are administratively difficult. However, one of the strongest arguments for CGT rests on



the grounds of adequacy, a comprehensive CGT is paramount to the collection of Government revenue.

Furthermore, having regard to the two generally accepted notions of tax equity, horizontal and vertical equity, the case for a comprehensive CGT is justified. Failing to tax capital gains is highly regressive since capital gains accrue disproportionately to the wealthy and this effectively shifts the tax burden to low and middle income taxpayers.

While many argue the introduction of a comprehensive CGT will add to complexity, others observe that a comprehensive CGT minimises the level of compliance and administrative costs.

In my view, the dominant reason why New Zealand should adopt a comprehensive CGT is to promote equity. People with the same taxable capacity should be taxed the same. This reason alone has been why a comprehensive CGT has been introduced into other countries worldwide.

Given the convergence of at least three of the tax policy criteria of efficiency, adequacy and equity, the case for the introduction of a comprehensive capital gains tax in New Zealand is justified.

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