



Is a Capital Gains Tax the Answer to New Zealand's Tax Alchemy

Is a Capital Gains the Answer to New Zealand's Tax Alchemy?

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Introduction

- New Zealand has no comprehensive CGT
- Judiciary steadfastly maintains income/capital dichotomy
- Given taxpayers tax equivalent of alchemy
- Tax free capital gains from capital investments
- They have struck gold!



Introduction

- 14 July 2011 NZ Labour Party released its key tax policies for upcoming election
- Broadening the tax base by introducing a CGT
- 15 March 2012 NZ Labour Party announced it will retain its plans for a CGT
- NZ Review Committees have in the past considered whether should introduce a CGT
- Some (and OECD) pro a CGT, some against a CGT
- Primary reason offered against a CGT is its complexity



Introduction

- Design issues that lend to the complexity
 - What is an “asset” for CGT purposes
 - What is a “realisation event” for CGT purposes
 - Equally, when is an asset “acquired”
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- These three design issues are considered through a comparative study of the CGT regimes in the United Kingdom, Australia and South Africa
 - The critical review of the CGTs in these Nations provides useful lessons for those considering the implementation of a CGT in New Zealand



Legislative history: United Kingdom

- Political discussions regarding introducing a CGT dating back to 1945
- Not introduced into legislation until *Finance Act 1965*
- Stemmed from 1955 *Minority Report of the Royal Commission on the Taxation of Profits and Income*
- Benefits of the CGT, eg the promotion of equity and reduction in economic distortion, outweighed expected high operating costs of the tax
- *Capital Gains Tax Act 1979*
- *Taxation of Chargeable Gains Act 1992* ('TCGA 1992')



Legislative history: United Kingdom

- Only applies to individuals and trustees
 - Gains made by companies are included in profits and subject to corporation tax
 - Present CGT rate is 18 percent when combined income and chargeable gains are £35,000 or less and thereafter 28 percent
 - CGT is payable only when taxable gains in excess of £10,600 per year
 - Two key elements are (i) “chargeable assets” and (ii) “chargeable disposal” for CGT purposes
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- UK CGT is an anti-avoidance measure – to prevent tax alchemy



Legislative history: Australia

- CGT had been recommended by the 1974 *Taxation Review Committee Report* ('Asprey Report')
- Again in the 1985 *Reform of the Australian Taxation System: Draft White Paper* ('White Paper')
- Original version introduced *Income Tax Assessment Amendment (Capital Gains) Act 1986* and the *Income Tax (Rates) Amendment (Capital Gains) Act 1986*
- Pt IIIA (ss 160A-160ZZU) in the *Income Tax Assessment Act 1936* (Cth) ('ITAA')
- Pt IIIA was subsequently rewritten in Chap 3 *Income Tax Assessment Act 1997* (Cth) ('ITAA 1997')



Legislative history: Australia

- CGT applies to all taxpayers
- Post 1999 in certain cases 50% discount extends to individuals, trusts and (33 1/3%) superannuation funds
- Pt IIIA *ITAA* three key elements are (i) asset, (ii) acquisition and (iii) disposal
- Chap 3 *ITAA 1997* key element is (i) CGT Event but also (ii) asset and (iii) acquisition



Legislative history: South Africa

- 1986 *Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa* ('Margo Commission Report' against a CGT
- 1995 *Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* ('Katz Commission') revived the debate for and against
- 23 February 2000 budget review: Minister of Finance announced that a CGT would be introduced
- 24 January 2001 briefing by the National Treasury's Tax Policy Chief Directorate to the Portfolio and Select Committees on Finance outlining the reasons for CGT
- *Taxation Laws Amendment Act 5 of 2001*, inserting the Eighth Schedule *Income Tax Act 58 of 1962* ('ITA 1962')



Legislative history: South Africa

- For individuals only 25% of the capital gain is assessable, other legal persons a 50% discount applies
- Annual exclusion of currently R17,500 individuals, deceased estates and special trusts
- Annual exclusion does not apply to companies, close corporations or trusts other than special trusts
- Two key elements are (i) asset and (ii) disposal
- Notion of “acquisition” is also addressed



Legislative scheme: United Kingdom

- Section 21 *TCGA 1992* is the charging provision: CGT is imposed on 'chargeable gains accruing to a person on the disposal of assets'
- The notion of a taxable capital gain revolves around 'chargeable assets' and 'chargeable disposal'
- Section 2 *TCGA 1992* includes individuals who are resident or those who domicile in the UK during the tax year in which the chargeable disposal occur
- Two key components are (i) 'chargeable asset' and (ii) the 'disposal' of a chargeable asset



Asset: United Kingdom

- The UK CGT does not contain specific 'acquisition' provisions. It has been addressed by the courts in the context of a "chargeable asset"
- All assets are chargeable assets unless they are legally exempted from CGT
- Section 21 of the TCGA 1992 defines assets as "all forms of property"
- Includes options, debts and incorporeal property, any non sterling currency and any form of property created by the person disposing of it, or otherwise coming to be owned without being acquired
- It applies to both tangible and intangible property



Asset: United Kingdom

- Broad interpretation of property (asset):
 - Assets 'owned without being acquired' (Kirby v Thorn)
 - A bundle of rights (O' Brien v Benson's Hosiery)
 - Legally enforceable rights for compensation (Kirby v Thorn, Zim Properties v Procter)
 - Assets that cannot be transferred by sale or gift
 - Choses in action for deferred consideration (Marren v Ingles)



Disposal: United Kingdom

- Primary disposal provision is s 21(2) and 22 *TCGA 1992*
- Section 22(1) provides “a disposal of an asset by their owners occur where any capital sum is derived from assets”
- Specifically states a disposal occurs notwithstanding that no asset is acquired by the person paying the capital sum
- Thus when a capital sum is derived from an asset, it is a disposal regardless of whether or not the person who pays the capital sum receives anything in return for his disposal: *Kirby v Thorn and Zim Properties v Procter*.



Disposal: United Kingdom

- Section 22(1) provides specific examples of disposals:
 - (a) Capital sums received by way of compensation for any kind of damage or injury to assets or for the loss, destruction of the asset
 - (b) Capital sums received under a policy of insurance of the risk of any kind of damage
 - (c) Capital sums received in return for forfeiture or surrender of rights, or for refraining from exercising rights
 - (d) Capital sums received as consideration for use or exploitation of assets



Disposal: United Kingdom

- The key issue is that capital sums were received
- Includes part disposals where an interest or right in or over the asset is created by the disposal
- Timing of the disposal is when the capital sum is received and/or when the deferred consideration became payable: *Marren v Ingles*.
- Where an asset is disposed of, disposal took place at the time of the contract and not when the full capital sum was received: *Lyons v Pettigrew*
- However with conditional contract, the disposal would have taken place with the fulfilment of the contract: s 28(2) *TCGA 1992*. See *Hatt v Newman*



Legislative scheme: Australia

- Section 102-5 is the charging provision: net capital gain is included in the taxpayer's statutory income, which is in turn assessable income under section 6-10 *ITAA 1997*
- Revolves around identifying a CGT Event: s 102-20
- Chap 3 *ITAA 1997* specifies a number of 'CGT Events' that may trigger a CGT liability
- It covers a wide range of transactions
- Concepts of 'asset', 'acquisition' and 'disposal' still play an important role for CGT purposes



Asset: Australia

- Section 108-5 *ITAA 1997* defines “asset” in extremely wide terms, extending to “any form of property” and “any kind of property” respectively
- Thus assets include legal and equitable interests in, and rights and powers over, both tangible and intangible property
- Shifting away from the United Kingdom approach by expressly extending to non-proprietary rights recognised by courts of law or equity
- Confining CGT assets to proprietary assets under the former s 160A *ITAA* has given rise to a number of controversial issues. See *Hepples v FCT*



Asset: Australia

- CGT assets need not be in a form of property and the term includes all legal and equitable rights such as personal choses in action, air space rights and water rights
- Personal knowledge and information 'know-how':
 - The Australian Taxation Office accepts that information such as know-how, by itself, is not a CGT asset
 - It is the right to obtain information, such as a contractual right to require the disclosure or non-disclosure of know-how, that is a CGT asset
 - Personal knowledge is incapable of disposal unless it constitutes a form of intellectual property



Asset: Australia

- Future asset: 'future property or right' not yet acquired or in existence could not be a CGT asset e.g. a shareholder's rights to future, undeclared dividends
- Not a mere expectancy and the asset should be recognised by a court of law or equity
- 'Popular rights' (such as the freedom to work or trade or to play amateur sports) are excluded from the CGT tax base
- A controversial issue - whether domestic currency, i.e. Australian dollar, is a CGT asset
- ATO has not been consistent in its approach. See Determination TD 2002/25 and ATO ID 2003/166



Acquisition: Australia

- Section 995-1 *ITAA 1997* defines the term “acquire”
- It states that a taxpayer “acquires a CGT asset at the time worked out under Division 109”
- Division 109 specifies the various ways in which a taxpayer can acquire a CGT asset and provides guidance on establishing the timing of acquisition
- Determining acquisition and its timing is particularly important in Australia as CGT will only apply to assets acquired after 19 September 1985
- The timing is also relevant for computing the indexation, CGT discounts and roll-over relief



Acquisition: Australia

- A comprehensive list of acquisition events
- The general rule is that a CGT asset is acquired with “a change in ownership” CGT Event A1
- The table in s 109-5(2) specifies how an asset may be acquired as a result of a specific CGT Event happening
- For example:
 - Hire purchase agreement triggering CGT Event B1
 - Creation of contractual right CGT Event D1
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Acquisition: Australia

- Section 109-10 provides guidance for a number of scenarios where a taxpayer acquires a CGT asset without a corresponding disposal or a CGT event
- These include:
 - creation and construction of assets
 - issue and allotment of shares and
 - issue of units in a unit trust by the trustee
- Note conflicting views on the timing of acquisitions of certain rights which exist in relation to land



Disposal: Australia

- CGT events approach - deeming certain transactions to be a disposal
- About 54 CGT events in total
- Section 102-25(1) specifies 'hierarchy' of CGT events
- Taxpayers must consider the relevance of all CGT events (except events D1 and H2 which serve as last resorts)
- Specific CGT events prevail over general CGT event
- Section 104-10: The most general CGT event provides that a CGT asset is disposed of if a change of ownership occurs
- Thus a specific CGT event will take precedence over the this general CGT event



Disposal: Australia

- Some CGT events are particularly problematic
- CGT event C2: a taxpayer's ownership of an intangible CGT asset ends in certain ways, e.g. the asset expires or is redeemed, cancelled, released, discharged, satisfied, abandoned, surrendered or forfeited
- Includes contractual performance: FCT v Orica



Disposal: Australia

- CGT event D1: creation of contractual or other rights in another entity
 - One of the catch-all, last resort provisions
 - Only applies if no other event but CGT event H2 applies
 - Not necessary to have acquired or disposed of an asset
 - Requires the computation of capital gain (or loss) and the identification of capital proceeds for creating contractual or other rights in another entity
 - Restricts the cost base to “the incidental costs incurred that relate to the event” only
- Note the interaction between the CGT event C2 and D1 (and also other CGT events). See Hepples



Legislative scheme: South Africa

- Section 26A *ITA 1962* is the charging provision: a person's taxable income includes their 'taxable capital gain'
- The notion of a taxable capital gain revolves around the 'disposal' of an 'asset': ss 3 and 4 *ITA 1962*
- Two key components are (i) an 'asset' and (ii) the 'disposal' of an asset
- Concept of 'acquisition' is given little attention



Legislative scheme: South Africa

Asset

- s 1 *ITA 1962* defines 'asset'
- Includes rights and interests in both corporeal and incorporeal objects
- Seemingly confined to proprietary assets
- First, both limbs of s 1(a) and (b) are tied to the notion of property
- Second, CGT legislation is premised on the subject asset being capable of being 'disposed': s 11
- Third, the rules providing for the timing of disposals are unworkable unless the asset is capable of transmission ie s 13(1)(a): the point when there has been a change in ownership of the asset



Asset: South Africa

- Notion of 'property' under South African focuses on whether the asset can be valued, rather than transferability
- However, the ability to value is dependent upon the ability to sell an asset to a third party
- Some rights are not capable of transmission and are not assets under the CGT legislation
- 'Personality rights' include matters such as the right to a reputation or privacy and cannot be divested
- A 'personal right' is the right to claim performance of an obligation ie under the terms of a contract, through a delict or other causes of actions
- Some personal rights cannot be divested ie *delectus personae*
- Note the issue re cession of future rights



Asset: South Africa

- Fourth, some provisions are premised on an asset being capable of being valued eg market value provisions
- Notion of 'property' under South African focuses on whether the asset can be valued
- Market value is dependent upon the ability to sell an asset to a third party
- Again "personality rights" and non-transferable "personal rights" are not capable of transmission
- What are known as 'popular' rights under English law, "such as personal liberty, parental authority and the rights flowing from the marital relationship ... [are] incapable of pecuniary evaluation" and thus are not proprietary assets within s 1



Acquisition: South Africa

- Part III is headed 'Disposal and acquisition of assets'
- No provision specifies what constitutes an acquisition
- The legislation just seems to assume an acquisition
- s 11(1) provides a disposal occurs when there is a "transfer ... of an asset"
- Both the prior acquisition of the asset by the vendor and the subsequent acquisition by the purchaser are not specifically provided for in the legislation
- s 11(1) provides for the disposal of an asset through the "creation ... of an asset"
- The actual acquisition of that asset is not dealt with



Acquisition: South Africa

- Does not deal with assets that are acquired without a corresponding disposal ie sculpture, invention
- Williams: drafters “nodded off” at this point
- s 11(1) provides for the disposal of an asset through the “creation ... of an asset”
- However, s 11 deems a disposal, not an acquisition
- Equally with vesting of shares / units, no disposal confirmed in s 11(2)(b), but no provision dealing with the acquisition
- No provision determining timing of these acquisitions
- Part of a broader problem with lack of timing rules for both acquisitions and disposals (ie s 13)



Disposal: South Africa

- Primary disposal provision is s 11(1): “disposal is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset”
- SARS: “must be interpreted in the context of the disposal of an asset”
- s 11(2)(a): disposal does not occur if change in ownership occurs as a result of providing or redeeming a security
- s 11(2)(b): issuing of shares does not constitute a disposal by the company
- Deemed disposals specified in s 12 eg emigration (s 12(2)), trading stock ceasing to be trading stock (s 12(3)) and reduction or discharge of a debt without the payment of full consideration (s 12(5))



Conclusion

- Introducing a CGT will broaden the New Zealand tax base and promote both equity and neutrality in the tax system
- However, as the above discussion highlights, these benefits may be lost through unnecessary complexity
- The experience in all three jurisdictions considered above shows some potential problems
- A New Zealand CGT would need to grapple with:
 - (i) breadth of the notion of 'asset'
 - (ii) whether the realisation transactions will extend beyond a change in ownership of an asset
 - (iii) the notion of acquisition, in particular when an asset is acquired without a corresponding disposal
- Huang and Elliffe: "One of the advantages of being the last to adopt something is that you can learn from others' mistakes"

