FORSYTH BARR

Equity Strategy

TWG Looks to Stretch Taxable "Income"

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The Tax Working Group finds in favour of including more capital income within the taxable base. This shouldn't impact company profitability and may actually favour nearer term Listed Property company earnings given the re-introduction of building depreciation. It would reduce returns from Australasian equites for NZ investors but given the marginal price setter for NZ equities are foreigner investors (who are not subject to the tax) we wouldn't anticipate any significant valuation impacts.

Taxation of capital income favoured

The Tax Working Group (TWG) has published its interim report. While final recommendations are still to be made the TWG appears to favour extending the tax net to include gains on assets that are not already taxed, specifically taxation of gains in:

- Land and property (other than the family home)
- Intangible property, including goodwill
- All other assets held by a business or for income producing purposes that are not already taxed on sale (such as plant and equipment)
- Shares in companies and other equity interests

The final recommendations won't be tabled until the Final Report in February 2019 but including more capital income into the taxable base appears to be favoured.

The TWG's estimates of income from imposing capital gains from realisation, however, appear minimal. Compared to the 2016/17 tax revenue of $76bn the incremental tax revenue is a mere ~+1% in year 2 and ~8% in year 10.

Figure 1. Projected revenue from taxing capital gains on realisation

Tax revenue $m	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Residential property ex family home	50	170	330	530	770	1,020	1,300	1,600	1,910	2,240
Other property	50	120	230	360	520	690	900	1,120	1,360	1,620
Rural land	30	70	140	220	310	400	510	610	730	840
Domestic shares	160	500	1,030	1,060	1,090	1,120	1,160	1,190	1,230	1,260
Total	**290**	**860**	**1,730**	**2,170**	**2,690**	**3,230**	**3,870**	**4,520**	**5,230**	**5,960**
% current tax base		**1.1%**	**2.3%**	**2.9%**	**3.6%**	**4.3%**	**5.1%**	**6.0%**	**6.9%**	**7.9%**

Source: Interim report Tax Working Group

Part of the reason is the tax would not be retrospective, rather based on gains after a valuation date. Weighed against the costs, the gains appear small so final implementation may not eventuate.

The costs, however, are mostly borne by the private sector hence this may be of less concern. That said, the projected revenue suggests implementation wouldn't be before 2021 and after the scheduled general election which must be held before 21 November 2020. This would be in line with the Government's pledge not to introduce any new taxes in this term.

Capital income tax favoured

The TWG is still forming its views on the best approach towards extending the taxation of capital income and acknowledges there are significant advantages and disadvantages that need to be considered. This will be done before the Final Report (February 2019).

Favoured structures so far seem to be as follows:

- The capital gains would be taxed as income and therefore at the marginal tax rate
- A valuation is still to be set but the tax is not expected to be retrospective
- Capital losses wouldn't be paid out as cash, rather carried forwarded. There appears to be ring fencing, however, with these losses only able to be used against same asset class gains
- Inflation indexing cost appears to be out of contention
- Retirement savings implications were reviewed as investment returns would be impacted by any capital gains tax. The solution favoured appears to be for the lower rates in variable rate PIE's to be lowered by 5% (Kiwisaver funds) as well as other concessions for low income earners such as the removal of the employer superannuation contribution tax. This would neutralise the impact for lower income groups
- Foreign owners of listed equities would not be caught by the tax. Foreign ownership represents nearly half the free float of the NZ equity market and as they are the marginal buyers of the NZ market we wouldn't anticipate a change in market valuation

Still some time before any implementation

The Government pledged no new taxes in its first term. Technically this could be couched as not a new tax — rather an extension of what could be deemed as income, however, we do not expect any implementation until post the 2020 election.

Firstly, recommendations won't be finalised until the February 2019 Final Report. The Government then needs to consider these, draft legislation, and then get this passed.

In the documentation, the first year for the tax to apply appears to be viewed as 2021/22. Legislated changes would, therefore, need to be in place before 31 March 2021, approximately two years after the Final report.

The last possible date for the next general election to be held is Saturday, 21 November 2020. This implies any introduction wouldn't be until after the 2020 general election.

Implications

If passed the introduction would pose a number of unintended consequences:

- Reduces the investment advantage of Australian equity investments vs. international and therefore potentially redirects investment flows more internationally
- The imputation system to avoid double-taxation is recommended to stay in place. The benefit of distributions from NZ corporates, therefore, remains but the change could incentivise corporates to favour higher dividends rather than seeking investment and expansion

Other outcomes from TWG

- No change to business tax rates are recommended
- No changes to GST rates or coverage are recommended
- A financial transaction tax was ruled out
- The door is open on Sugar, Congestion and additional Gaming taxes, albeit the government policy needs to be articulated first before the appropriate structures could be considered.