THE TAXATION OF CAPITAL GAINS IN NEW ZEALAND

A review of the options and problems of introducing such a tax

An Occasional Paper
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The Institute wishes to place on record its thanks for the time given by members of these committees, and for their contribution to the studies.

INTRODUCTION

In *How Should Business be Taxed?*[1] Paul Bevin suggested that reforming the taxation of business income could not be separated from the taxation of personal investment income. He argued that five major steps were required to achieve a sustainable income tax regime:

— flatten the personal marginal tax scale;
— remove existing tax preferences for certain kinds of investment;
— eliminate the separate taxation of companies and their shareholders;
— inflation-adjust business and investment income;
— tax capital gains as ordinary income.

All of these measures were seen as necessary ingredients in a reformed income tax.

The Government has already announced a major lowering and flattening of the personal income tax scale, the full imputation of company taxes on dividends to their shareholders, and many tax preferences have been removed in recent years. Inflation-adjustment and capital gains have not been addressed. In practice, these features cannot be considered independently. For example, taxation of capital gains raises the issue of excluding the inflationary component of gains and of interest (which contains an equivalent inflationary premium) - both interest income and interest expense, which would ordinarily be deductible against business capital gains as well as other income. Similarly, the regime of company/shareholder taxation affects the appropriate form of taxing capital gains on shares. In other words, these issues will have to be addressed in designing appropriate reforms and a comprehensive or integrated approach is necessary if reforms are to be sustainable.

In addition to the well known cases provided explicitly in the Income Tax Act 1976 where the profit on certain land and real property transactions is taxable, capital gains are taxed in some less obvious ways. These include, for example:

— the interest and development expenditure claw-back provisions of section 129 (which are to be repealed in certain cases);
— capital gains derived by life insurance companies and other specialised investment businesses;
— increases in the value of trading stock of a business;

— gains and losses on foreign exchange transactions including those on foreign currency denominated loans.

Like it or not, therefore, the tax law has already addressed the capital gains tax issue in certain rather arbitrarily defined circumstances.

The purpose of this paper is to canvas some of the main issues involved in determining how capital gains could be brought into the general income tax law. The first sections examine the nature of capital gains and how they are presently taxed in New Zealand. After looking briefly at the arguments for capital gains taxation, the main focus of the paper is on the practical problems of such taxes with particular reference to the Canadian and Australian legislation. Some tentative conclusions round off the paper.

WHAT ARE CAPITAL GAINS?

A capital gain is "that form of gain that arises to the owner when some property of his appreciates in value or when he realises it at a price greater than its cost of acquisition".[2] Under New Zealand law, capital gains are generally not regarded as assessable income. Adopting the analogy of capital as a tree, the fruit of the tree may be seen as income but other accretions - increase in size and greater fruit bearing capacity - are something else: capital gains.

Compare this with an economist's definition of income as "the money value of the net accretion to one's economic power between two points of time".[3] Here, the lawyer's distinction between income and capital gains is ignored. Proponents of a comprehensive tax base seek to define income in such all-embracing terms[4] and then, if it is thought necessary, for the purposes of implementing laws, state items that will not be liable for taxation.[5] Important features of a comprehensive tax base are:

— no distinction is made between different types of real gains: they are all income and should be taxed accordingly;
— accrued as well as realised gains; and
— only real gains, as opposed to illusory gains are assessable.

Capital gains arise in a number of different ways[6], some of which reflect a real increase in wealth and some of which do not. Gains which correspond to rises in the price level or which are eaten up by expenses - solicitors fees, agents fees, stamp duty etc. - are illusory. The recipient has no greater capacity to pay as a result of receiving his gain. The distinction between real and illusory gains is crucial to any equitable system of income taxation.

TO WHAT EXTENT ARE CAPITAL GAINS TAXED IN NEW ZEALAND?

There is no comprehensive capital gains tax in New Zealand. Capital gains are taxed only to the extent that they fall within the specific provisions of the Income Tax Act 1976. In particular section 65(2) lists a number of items that are deemed to be included as assessable income. These include the following:

65(2)(a) All profits or gains derived from any business (including any increase in the value of stock in hand at the time of the transfer or sale of the business, or on the reconstruction of a company).

The term "*business*" is defined in section (2) to include "*any profession, manufacture or undertaking carried on for pecuniary profit*". Although this is an inclusive definition, the courts have not regarded as business any activity that is outside of it.[7] Thus "business" is limited by the words "carried on" so as to exclude isolated transactions. And the words "for pecuniary profit" impose a requirement that a person have a specified intention in respect of his activities before they can be regarded as business.

This requirement has both a subjective element - what the taxpayer claims to be his intentions - and an objective element - what his activities suggest his intentions to be. As Richardson said in *Grieve v Commissioner of Inland Revenue*:[8]

" *the decision whether or not a taxpayer is in business involves a two-fold inquiry - as to the nature of the activities carried on, and as to the intention of the taxpayer on engaging in those activities. Statements by the taxpayer as to his intentions are of course relevant but actions will often speak louder than words. Amongst the matter which may properly be considered in that inquiry are the nature of the activity, the period over which it is engaged in, the scale of operations and the volume of transactions, the commitment of time, money and effort, the pattern of activity, and the financial results. It may be helpful to consider whether the operations involved are of the same kind and are carried on in the same way as those which are characteristic of ordinary trade in the line of business in which the venture was conducted. However, in the end it is the character and circumstances of the particular venture which are crucial. Businesses do not cease to be businesses because they are carried on idiosyncratically or inefficiently or unprofitably,*[9] *or because the taxpayer derives personal satisfaction from the venture.*"

65(2)(e) All profits or gains derived from the sale or other disposition of any personal property or any interest therein (not being property or any interest therein which consists of land within the meaning of section 67 of this Act), if the business of the taxpayer comprises dealing in such property, or if the property was acquired for the purpose of selling or otherwise disposing of it, and all profits or gains derived from the carrying on or carrying out of any undertaking or scheme entered into or devised for the purpose of making a profit.

This paragraph comprises three limbs. Both the first and third limbs appear to have very limited scope. It is apparent from the cases that the first limb (profits from the sale of personal property if the business of the taxpayer comprises dealing in such property) does not apply to property held and disposed of as a capital asset. It applies only to property disposed of as part of the taxpayer's business of dealing in such property.[10] Thus it seems that any profit or gain that could be caught by the first limb would almost certainly be caught by section 65(2)(a).[11] Similarly, there seems to be little or no scope for the independent operation of the third limb (profits or gains derived from the carrying on or carrying out of any undertaking or scheme entered into or devised for the purpose of making a profit). The situations to which it could apply appear to be covered by the second limb and by sections 65(2)(a) and 67.[12]

The second limb includes any assessable income, profits or gains from the sale or other disposition of personal property where the property was acquired for the purpose of selling or otherwise disposing of it. Unlike section 65(2)(a) and the other limbs of section 65(2)(e), it is directly concerned with profits from isolated transactions and may be seen as a limited form of capital gains tax. However, it too has its limitations. It applies only where personal property is acquired with the dominant purpose of selling or otherwise disposing of it.[13] This involves an artificial exercise in quantifying 'purpose'. Also, it is an incentive to dishonesty and has been a source of much litigation.[14]

65(2)(f) All profits or gains derived from the sale or other disposition of any land within the meaning of section 67 of this Act, being profits or gains to which that section applies.

Section 67 which is referred to in section 65(2)(f) comprises a code for the taxation of profits and gains from the sale of land. Sub-section (4) sets out six categories of profits or gains which may be taxable. They are:

(a) where the land is acquired with the purpose or intention of selling or otherwise disposing of it;

(b) where the taxpayer is a dealer in land and, having acquired the land for the purpose of his business of dealing in land, disposed of it within ten years of acquiring it;

(c) where the taxpayer is a builder and, having acquired the land for the purpose of his business as a builder and carried out improvements on it, disposed of it within ten years after the date on which the improvements were completed;

(d) where the land appreciated in value because of rezoning or similar events;

(e) where the land has been developed or subdivided within ten years of its acquisition;

(f) where the land has been developed or subdivided and the profits do not fall within the other five categories and they are derived from the carrying on or the carrying out of any undertaking or scheme involving the development or divisions into lots of the land.

All six categories are subject to specified exemptions, the most important of which are in respect of business premises and dwellinghouses. These apply to paragraphs (a) (land acquired for the purpose or intention of sale), (b) (dealers) and (c) (builders).

Section 67 is much wider in scope than the second limb of section 65(2)(e) which applies to isolated transactions in respect of personal property. However, it is by no means a comprehensive code. The circumstances set out in sub-section (4), in which profits from the sale of land will be assessable, are all very specific and, like section 65(2)(e), are bedevilled with requirements that the taxpayer have a particular purpose at the time he acquires the land.

65(2)(g) All rents, fines, premiums or other revenues (including payment for or in respect of the goodwill of any business, or the benefit of any statutory licence or privilege) derived by the owner of land from any lease, licence, or easement, affecting the land, or from the grant of any right of taking the profits thereof.

This includes two items - premiums and payments for or in respect of the goodwill of any business - which in their ordinary legal sense would be regarded as capital gains. Again, the context is limited in that they must be derived by an owner of land from any lease, licence or easement affecting the land or from the grant of any right of taking the profits thereof.

65(2)(l) Income derived from any other source whatsoever.

This is a general 'catch-all' provision which could apply to capital gains if they come within our general concepts of income. However, the courts have been loath to recognise that any provision of the Act applies to capital gains.[15] As North, J. said in *CIR v Walker*[16], "we are dealing with a taxing statute aimed at requiring persons to pay tax on income as distinct from what may loosely be described as gains derived from a capital source". The courts take the view that the Act must express its intention in clear and unequivocal words before capital gains can be taxed as income.

There are a number of other provisions in the Act which, in very specific situations, make assessable profits or deemed profits which are not within the traditional legal concepts of income.[17]

One further comment should be made about assessable gains under the Act: no distinction is made between real gains and purely inflationary gains. The Privy Council in *Lowe v Commissioner of Inland Revenue*[18] recently held that inflation could not be taken into account when calculating profits under section 88A of the Land and Income Tax Act 1954 (now section 67 of the Income Tax Act 1976). The taxpayers were assessed on a profit of $15,566.50 which had accrued over a period of 12 years. They submitted that much of that profit was illusory - the result of inflation - and that the amount to be assessed should be a lesser sum based on some current cost accounting method. However, as Lord Templeman said in delivering the judgment of the Privy Council[19], "by the practice of law of New Zealand a profit or loss for income tax purposes can only be measured in the present circumstances by the difference between dollars expended and dollars received".

Conclusions

(1) There are a number of provisions in the Income Tax Act that deem capital gains to be assessable income. However, these provisions (a) do not comprise a comprehensive code, (b) are very specific, and (c) are not inter-related.

(2) Allowance is made for inflation. As a result, taxes may be imposed at high rates on small real gains or on real losses.
(3) Many of the provisions contain a requirement that the taxpayer have a particular purpose at some time during his profit making activity. It is submitted that a requirement of purpose has no bearing on a person's capacity to pay and that it should be irrelevant to whether or not a profit or gain is assessable.[20]
(4) The courts have taken the view that capital gains are not assessable unless clear and unequivocal words are used to say that they are.

THE ARGUMENTS FOR A CAPITAL GAINS TAX

1. Equity

There are two aspects of the equity argument:

— Horizontal equity - people equally placed should bear equal tax burdens.
— Vertical equity - wealthier people should bear a proportionately greater tax burden than poorer people.

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 assessable income and, in the other, of both assessable income and non assessable capital gains. It is suggested that, as they have the same capacity to pay, they should bear the same burden of taxation. Of course, there are many reasons why the two taxpayers may not be equally placed - for example, the capital gains received by one may be simply the result of inflation - but this does not undermine the argument which in the context of capital gains could be restated as follows: "Where as a result of receiving capital gains, one taxpayer is equally placed with another taxpayer, the two should bear equal tax burdens".

The second aspect of the equity argument - wealthier people should bear a greater tax burden than poorer people - is recognised in our general tax system, by the imposition of graduated tax rates. It would seem that the failure to tax capital gains has an effect diametrically opposed to the principle of vertical equity. As income other than capital gains is typically the primary source of money for poorer people, they pay tax on most of what they receive. Wealthier people are more likely to receive their money in the form of both assessable income and non-assessable capital gains with the result that they may bear a tax burden less than the progressive rate schedule would suggest. To redress this imbalance and to achieve a degree of vertical equity, a capital gains tax would seem desirable.

2. Efficiency

In *How Should Business be Taxed?*[21] Paul Bevin pointed out that the exclusion of capital gains from taxation contributes to highly uneven effective rates of tax on different investments and to the consequent misallocation of resources. As a result, resources are diverted into activities which obtain lower pre-tax rates of return. The effect is to lower national income and standards of living.

3. Tax Minimisation

Immunity from tax of capital gains is an incentive to tax planners to employ various devices to convert income receipts to capital receipts. In New Zealand, these attempts are, to some extent, limited by a general tax minimisation provision in the Income Tax Act 1976. Section 99(2) provides:

Every arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner for Income Tax purposes if and to the extent that, directly or indirectly -

(a) Its purpose or effect is tax avoidance; or

(b) Where it has two or more purposes or effects, one of its purposes or effects (not being a merely incidental purpose or effect) is tax avoidance, whether or not any other or others of its purposes or effects relate to, or are referable to, ordinary business or family dealings, -

whether or not any person affected by that arrangement is a party thereto.

The general nature of this provision reduces its effectiveness. For it to apply, it is necessary to establish that there has been an arrangement the purpose or effect or one of the purposes or effects of which is tax avoidance. While many capital receipts may arise in this way, the arrangements and their purposes or effects are not easy to detect. The problem would be eliminated if capital gains, per se, were taxable regardless of how they arose.

The argument that we should have a capital gains tax so as to check tax minimisation may be disputed on the ground that some degree of tax minimisation is desirable because it rewards risk and acts as a safety valve against more dishonest practices.

The "safety valve" contention is usually put on the basis that people should be given scope to legitimately arrange their affairs so as to incur the minimum amount of tax. If they are put in the position whereby the only way to do this is to earn less money, then either they will lose their urge to produce, with the result that the economy will stagnate, or they will resort to illegitimate means to minimise their tax burden.

This may be correct, but it is not a valid argument against a capital gains tax. It is an argument against excessive taxation. A broadly based tax system which includes capital gains tax would permit a lower more uniform basis of personal taxation.

4. Other Arguments

Other arguments in favour of a capital gains tax usually arise in opposition to arguments against a capital gains tax. These are considered below. It is not suggested that capital gains should be taxed because, per se, they would be a source of revenue. In a system which properly taxes only real gains and takes into account real losses, capital gains and losses may, in the long run, cancel each other out.[22] However, by closing a major tax avoidance loophole, there should be a substantial gain to revenue which would promote equity and efficiency and result in significant tax reductions.

THE ARGUMENTS AGAINST A CAPITAL GAINS TAX

1. Perception and treatment of capital gains

While capital gains, like income, may accrue on a relatively regular basis, they are realised only occasionally. Thus, it has been said that we cannot rely on them in our domestic affairs as we would rely on our other more regular income.[23] They are likely to be treated as additions to capital which are not available for consumption. Consequently, taxes on capital gains are open to the criticism that they are imposed more severely on the supply of savings than are taxes on more regular income.

This argument which appears quite strong when considered in isolation loses much of its force when considered in the broader context of the 'capacity to pay' basis of taxation.

At present, those people whose savings derive primarily from assessable income are taxed on the source of most of their savings. Those people whose savings derive more from non-assessable capital gains are taxed to a lesser extent on the source of their savings. A capital gains tax would spread the burden more fairly so that, to the extent that savings would be taxed, all savings of all taxpayers would be taxed.

2. The double tax argument

The assumption behind this argument is that capital gains are increases in the present value of expected future income. If we had a capital gains tax, such gains would be taxed twice; first on the capital value of future incomes and secondly, on the incomes as they are received. However, because the tax is not applied at the time capital gains occur but is effectively delayed until the future income is taxed, the tax on the capital gains is less than that which would apply if they were taxed on accrual.[24] It should be noted that all income taxes penalise savings; not just capital gains taxes. The issue is really one of the advantages of taxes on income versus taxes on consumption.[25]

3. Other arguments

A number of other arguments have been put in opposition to a capital gains tax. Some have been dealt with in passing, for example, the suggestion that a capital gains tax would not be a significant source of revenue. Others may be described as administrative. They pose problems in the imposition of a tax but, if they can be satisfactorily solved, they no longer exist as reasons for not having a capital gains tax. Of course, one aspect of satisfactorily solving these problems is to ensure that in the attempt to do so, the tax structure created is not so complex, cumbersome and costly as to negate any good results that might ensue from having a capital gains tax. A poorly designed tax would simply create a new set of tax distortions and a fertile field for tax consultants. Administrative practicality is therefore critical.

PARTICULAR PROBLEMS OF IMPLEMENTING A CAPITAL GAINS TAX

The problems discussed in this section have been dealt with in different ways by the various countries that have capital gains taxation. In this paper, particular attention is paid to the solutions adopted by the Canadian Income Tax Act 1971 and the Australian Income Assessment (Capital Gains) Act 1986 partly because they are the result of intensive and detailed inquiries into taxation reform[26] and partly because, of the four major English-speaking jurisdictions to have introduced capital gains taxation - the others being the United States of America and the United Kingdom -, the Canadian and Australian legislations are, to this writer, the most comprehensible.

1. Accrual or realisation

It is arguable that if capital gains were to be taxed, they should, like income, be taxed on an accrual basis or at least, on an annual basis. This, as the Carter Commission pointed out, would be consistent with the principle of the "comprehensive tax base". Thus,[27]

> *"To be consistent with the principle of the comprehensive tax base, net gains on assets should in principle be brought into income annually, whether the gains were realised or not. This would preclude tax postponement, and if time were provided to pay the tax on the gains, serious liquidity problems could be avoided. Taxing gains on a realised basis allows for tax postponement and may induce holders of property not to realise their gain in order to avoid the tax. Furthermore, if gains were taxed annually, whether realised or not, the postponement of tax through the retention of income in corporations, trusts and mutual organisations would not pose a problem. There would be no reason to collect tax from these organisations except to obtain tax from non-residents and to prevent tax avoidance."*

However, despite the theoretical merit of taxing capital gains in this way, it is widely recognised that to do so would be impractical.[28] It is not done in any of the countries which tax capital gains. There seem to be two main objections. First, an accrual or annual basis would require periodic valuations of all the assets of all taxpayers. This should not be a major problem. Although some assets - for example, shares in unlisted companies - are difficult to value, many others are already valued on a regular basis for income tax or insurance reasons. It would, however, be costly for, and a source of perpetual annoyance to, taxpayers who would regularly have to make detailed tax returns. Secondly, if at the time of assessment a taxpayer has not recently realised the asset in respect of which there has been a gain, he is likely to have difficulty in paying the amount assessed. Without realisation, he may have no cash from which the tax can be paid. It is suggested that if gains were to be taxed on an accruals basis, taxpayers would have to be given some assistance in the form of a government loan or a deferral of liability.[29] In any case, it is submitted that the prospect of having to realise assets or go into debt so that tax assessed on an accruals basis could be paid would be most unpopular with taxpayers.

A further problem is that if capital gains were to be taxed on an accruals basis and, presumably, capital losses were allowed also on an accruals basis, there might arise a situation where, with fluctuating values, taxpayers were continuously paying tax and receiving refunds in respect of assets that ultimately give rise to no gain.

The alternative system of taxing gains - after they have been realised - also has its drawbacks. It can result in a 'lock-in'[30] whereby taxpayers defer paying tax by holding on to their assets. It can result also in taxpayers realising their assets when their values have decreased and thus claiming a capital loss. Those countries that have a comprehensive capital gains tax prefer a realisation basis, it seems, because it has the attribute of simplicity. Nevertheless, they modify this basis by deeming gains to be realised in certain circumstances[31] and by attempting to take inflation into account so that the gains are not assessed as if they all accrued at the time of realisation.[32]

2. The 'lock-in'

A capital gains tax levied only on realisation is likely to have the effect of locking investors into their holdings.[33] People will prefer to retain their assets as they are rather then sell them and pay tax on the profit.

The 'lock-in' is said to have undesirable consequences.[34] Thus, when stock prices are rising, supply is short, and when the market weakens, the desire for deductible losses leads to increased sales. The desire for deductible losses is said also to create an additional source of uncertainty and instability in the market.

Another consequence may be a tendency for people who have succeeded in one capital venture to refrain from moving into other successful ventures. As a result, capital is less likely to be moved into new higher yielding investments.

Other than taxing capital gains on an accruals or accruals equivalent basis, there is no way of eliminating the 'lock-in' effect. However, it can be reduced in some circumstances by imposing a tax on the deemed realisation of assets.

Deemed realisation of assets allows for partial deferment of liability but prevents permanent deferment. In Canada, this method has been adopted in four situations:

(a) Ceasing and commencing to be a Canadian resident

A taxpayer who ceases to be resident in Canada is deemed, immediately before that time, to have disposed of each property which he owned immediately before he became a non- resident (with certain exceptions) and to have received proceeds of disposition equal to the fair market value at the time he was deemed to have disposed of it.[35]

A taxpayer is (with some exceptions) also deemed, immediately before he became a Canadian resident, to have acquired at a fair market value, any property which he owned before he became a resident.[36]

(b) Change in use of property

If a taxpayer acquires property for the purpose of gaining or producing income from the property or from a business and later uses it for some other purpose, or *vice versa*, he is deemed at the time of the change in use to have disposed of the property for proceeds equal to the fair market value of the property at the time and to have reacquired the property immediately thereafter, also at the fair market value.[37]

Provision is also made for calculating a deemed value of disposal and acquisition when the property had been used partly for the purpose of gaining and producing income and partly for some other purpose.[38]

(c) Gift

A taxpayer who disposes of property by way of gift or for consideration at less than its fair market value is deemed to have received proceeds of disposition equal to the fair market value of the property.[39]

(d) Death

On the death of a taxpayer, he is deemed to have disposed, immediately before his death, at a fair market value, of each item of non-depreciable capital property owned by him at the time of his death.[40] A beneficiary, under a will or intestacy, of non-depreciable capital property is deemed to have acquired it for a cost of the same amount which the deceased is deemed to have received as his proceeds of disposition.[41] Special provisions apply where capital property is transferred either by way of *inter-vivos* gift or on death to a spouse or a 'spouse trust' so that no capital gains or losses are realised at that time.[42] Also, generally, a taxpayer who fulfils certain conditions is permitted to pass a family farm on death or by way of *inter-vivos* gift without the consequences of a deemed realisation.[43]

It may seem harsh to impose a capital gains tax when a person dies or makes a gift. At the same time, another tax in the form of death duty or gift duty may be imposed on the unrealised gain. This argument seems to be based on the fallacy that what is being taxed - the gain - suddenly came into existence at the time of the death or the gift whereas, in fact, it accrued over a period of time before that.

In Australia, a realisation (disposal) is deemed to take place when a taxpayer ceases or commences to be an Australian resident.[44] A realisation is also deemed to take place when a taxpayer makes a declaration of trust or releases, discharges, satisfies, surrenders, forfeits or abandons a debt, chose in action or any other right.[45] However, a gift or death does not give rise to a deemed realisation although capital gains tax will be levied when the assets of a deceased person are realised by the administrator of his estate or disposed of by a beneficiary.[46]

One problem with a deemed realisation is that, as there has been no actual realisation, the taxpayer may not have sufficient funds to pay the tax. This would occur particularly in the case of estates consisting largely of non- liquid assets such as farm property or shares in a private company. The problem would be compounded by the liability to pay other debts, notably death duty and gift duty. It may be appropriate in these cases to make some provision for deferment of liability subject to a market rate of interest.[47]

The other problem, as the Canadian and Australian legislation show, is that deemed realisation is itself complex and fraught with provisos, exceptions and loopholes. It has its merits but nevertheless it is a limited partial solution to the problem of the 'lock-in'.

3. Illusory gains - the problem of inflation

We have seen that some capital gains are illusory. They result from inflation and merely reflect a rise in the general price level. It may be said that a tax on gains of this nature does not operate as a true capital gains tax because there is not a true capital gain to be taxed. Instead, it operates as a wealth tax.

It is suggested that if there is to be a capital gains tax some allowance should be made for inflation.[48] In those circumstances where capital gains are taxed in New Zealand no allowance is made for inflation,[49] with the result that taxes may be imposed at very high rates on small and non-existent gains.

The methods adopted by other countries in dealing with the problem are barely more sophisticated. In Canada, one-half of a taxpayer's taxable capital gain is included in his income[50] and, subject to certain exceptions, one-half of his capital loss may be set off against taxable capital gains.[51] This solution may be in recognition of the fact that by the time many gains are realised their real value will be less than the money amount received by the taxpayer. But it is very rough and ready. It makes no distinction between gains that accrue over a short term and gains that accrue over a longer term.

The American solution is little better. There, short term capital gains - that is, gains from the sale or exchange of capital assets held for not more than six months[52] - are taxed at rates applicable to other income.[53] Long term capital gains - gains from the sale or exchange of capital assets held for more than six months[54] - are taxed at more favourable rates.[55]

Distinguishing between long and short term gains eases the burden for taxpayers whose property appreciates in value over a long period of time, but for such a system to operate fairly, it is necessary to distinguish not just between two periods but between a number of periods. Under the United States system, the taxpayer whose profit accrued over thirty years is taxed in the same way as the taxpayer whose profit accrued over one year.

An objection to distinguishing between long and short term capital gains is that it would encourage tax avoidance. A taxpayer anticipating a profit may very likely defer selling property until the short term profit period had expired. He would then qualify for a lower tax rate. If instead, he anticipated a loss he might be encouraged to sell quickly and qualify for a high deduction.

Unlike the Canadian and United States systems, the Australian system takes into account both rates of inflation and actual periods of ownership. The gain is calculated by deducting the original cost of the asset increased for inflation between the date of purchase and the date of sale from the proceeds of disposal.[56]

Example[57]

A taxpayer acquires an asset for $10,000 on 1 July 1986 and sells it for $22,000 on 1 July 1996. The Consumer Price Index at the time of purchase is 100 and 200 at the time of sale. The taxable real capital gain is calculated as follows:-

Proceed of disposal		$22,500
less original cost increased for inflation between date of purchase and date of sale	$10,000 x $\frac{200}{100}$=	20,000
Taxable gain		$2,500

4. "Bunching"

In a system of progressive tax rates, it may be unfair in some cases where property increased in value over a long period of time, to treat the whole profit from the sale of that property as part of the income of the year of sale. The problem would be solved if taxable gains were spread over the period that the taxpayer owned the property the sale of which gave rise to the gain. This has not been adopted anywhere apparently because the problem is considered not big enough to justify such a complex solution. As pointed out in the 1985 Australian draft White Paper, it is only a problem if the incremental income from capital gains is sufficient to push the taxpayer into a higher tax bracket; 'bunching' imposes no penalty on taxpayers already facing the top marginal rate in the absence of income from capital gains .[58]

5. Treatment of losses

If profitable realisations are treated as taxable income, then it would seem fair to treat unprofitable realisations as deductible losses. It is a generally accepted principle that, in calculating libability to taxation, income related losses may be set off against income. In New Zealand, this is given statutory form by section 104 of the Income Tax Act 1976. Countries which have some form of comprehensive capital gains tax make provision for the deduction of capital losses. In Canada, capital losses from the disposition of property are computed in a similar way to capital gain. One half of capital losses may, with certain exception such as losses from personal use assets[59], be set off against capital gains.[60] No attempt is made to deal with the problem of taxpayers realising their unprofitable investments when it suits them in order to obtain deductions. In Australia, realised capital losses may be set off in full against capital gains realised in the same year or they may be carried forward and set off against capital gains in subsequent years.[61]

6. Exceptions

Capital gains in practice seem always to be subject to certain exclusions and exemptions. In the United States, the United Kingdom and Canada, special treatment is accorded to certain types of property, notably residential houses[62], and in the United Kingdom and Canada certain small gains are exempted from taxation.

In Australia, gains on the disposal of a taxpayer's principal residence are exempt.[63] A principal residence may include up to 2 hectares of attached land if it is used for private and domestic purposes.[64] Also excluded are various gains to which other provisions of the Income Tax Assessment Act apply, gains on the disposal of specified motor cars, gains on the disposal of decorations for valour or bravery, compensation or damages for wrong or injuries, lotteries and gambling gains and prizes from games.[65]

The special treatment accorded to private residences reflects the high regard which societies like ours place on home ownership. When one home is sold, the proceeds of the sale are frequently put towards the purchase of another home. The taxpayer might have received a high price on the sale but, as he would be looking to purchase his next home in the same inflated market, he may expect to pay a similarly high price. If the profit from the sale is subject to capital gains tax, he might have difficulty in buying another home of similar standard. A capital gains tax may also discourage older people from moving out of larger homes into smaller homes when their housing needs change.

A further problem in respect of taxing profits from the sale of private residences relates to the computation of the gain. Taking into account the cost of improvements and repairs, this could be quite a problem especially where the houses have been owned by the same persons for long periods.

Calculating the gain

Most countries which tax capital gains do not tax them in full. Some, like the United States, tax short term gains at high rates and long term gains at low rates. Some, like Canada, tax gains as to only one half. The reason for not taxing gains in full may have something to do with the failure of these countries adequately to take inflation into account in calculating the gain. On the other hand, the Australian provisions, which realistically take inflation into account, provide for the tax to be levied on the full gain at ordinary rates of personal and company income tax. Whatever may be the proportion made liable to taxation, it is important that the gain is in fact a net gain. A gain of $1,000 that cost $1,000 to produce is no gain. Under the Australian provisions, the following types of expenditure are included in the asset cost base:[66]

(a) the amount of any consideration in respect of the acquisition of the asset;
(b) the amount of the incidental costs to the taxpayer of the acquisition of the asset;
(c) the amount of any expenditure of a capital nature incurred by the taxpayer to the extent to which it was incurred for the purpose of enhancing the value of the asset and is reflected in the state or nature of the asset at the time of disposal of the asset;
(d) the amount of any expenditure of a capital nature incurred by the taxpayer to the extent to which it was incurred in establishing, preserving or defending the taxpayer's title to, or a right over, the asset; and
(e) the amount of the incidental costs to the taxpayer of the disposal of the asset.

Incidental costs to the taxpayer of the acquisition of an asset and the disposal of an asset comprise the following items:[67]

(a) fees, commission or remuneration for the professional services of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal advisor;
(b) costs of transfer, including stamp duty or other similar duty;
(c) costs in advertising to find a buyer or a seller;
(d) costs in relation to the making of any valuation or apportionment under or for the purposes of the capital gains provisions of the Act in respect of the acquisition or the disposal.

The following example illustrates the calculation of a capital gain, taking into account the cost of improvements to the property and inflation both in respect of the original cost of the property and the cost of the improvements:[68]

<u>Example</u>

A taxpayer acquires an asset for $10,000 on 1 July 1986, carried out improvements costing $3,000 on 1 July 1991, and sells the asset for $25,000 on 1 July 1996. The CPI index at purchase was 100, at the time of improvement was 150 and at the time of sale was 200.

Proceeds of disposal		$25,000
less original cost increased for inflation between date of purchase and date of sale	$10{,}000 \times \frac{200}{100} =$	20,000
less cost of improvements increased for inflation between date expenditure was incurred and date of sale	$3{,}000 \times \frac{200}{150} =$	4,000
Taxable gain		$1,000

CONCLUSION

The major obstacles to an equitable capital gains tax derive from the fact that, while the most practical basis for taxing them is on realisation, they usually accrue over a number of years before that time. Three problems that may result are:

(1) a 'lock-in' whereby taxpayers defer paying tax by holding on to their assets;
(2) illusory gains: gains that result from inflation and merely reflect a rise in the price level; and
(3) the bunching together of gains that accrue over a number of years into the year of realisation so that they are assessed as if they all accrued in that year.

These problems are not insurmountable. They would all be resolved if taxation was on an accruals basis. However, this has problems of its own; in particular, it would result in a situation whereby people would be taxed on gains at times when they did not have the funds to pay. Rather, it is suggested that capital gains be taxed generally on a realisation basis with provisions for deemed realisation. The problems of illusory gains and 'bunching' could be resolved by taking into account inflation rates so as to ascertain real gains and by spreading taxable gains over actual periods of ownership. In such circumstances, capital gains should be assessed and capital losses allowed at full income tax rates.

The present provisions dealing with capital gains are limited in their application and easily avoided. In the circumstances where they do apply no allowance is made for inflation or the bunching of gains into one year. Any taxpayer who is caught by the provisions is liable to be taxed at a high rate on small or non-existent gains. It is submitted that there is a strong case for getting rid of the existing provisions. And, it is submitted that there is a strong case based on equity and the prevention of undesirable tax minimisation for replacing the existing provisions with a complete code for taxing capital gains.

Finally, it is submitted that the code should incorporate the following features:

- the tax should be levied upon the realisation of assets;
- it should be levied at ordinary income tax rates;
- it should be imposed on real capital gains calculated by indexing the asset cost base;

- it should take into account expenditure associated with the purchase, improvement and disposal of assets subject to the tax;
- it should allow for realised losses to be set off against realised gains; and
- it should grant complete exemption of the taxpayer's principal residence.

REFERENCES AND NOTES

1. P. Bevin, *How Should Business be Taxed?* Victoria University Press for the Institute of Policy Studies, 1985.
2. *Royal Commission on Taxation of Profits and Income* (UK) Final Report - Cmnd 9474 - 1955 (*Radcliffe Report*), para 82, p 26.

   C.f.*Taxation in New Zealand.* Report of the Taxation Review Committee, Wellington, 1967 (*Ross Report*), para 984, p 402: "A capital gain may be said to have accrued whenever a capital asset increases in value".
3. R M Haig, 'The Concept of Income' in *The Federal Income Tax*, ed Haig, New York, Columbia University Press, 1921, p 7.
4. See also H Simons *Personal Income Taxation* , University of Chicago Press, Chicago, 1938, p 105.
5. The comprehensive tax base as a basis for tax reform is debated in volumes 80 and 81 of the *Harvard Law Review* in the following articles: Boris I Bittker, 'A "Comprehensive Tax Base" as a Goal of Income Tax Reform' *HLR* 80 (1967) p 925; R A Musgrave, 'In Defence of an Income Concept ' *HLR* 81 (1967) p 44; Joseph A Pechman, 'Comprehensive Income Taxation - A Comment' *HLR* 81 (1967) p 63; Charles O Galvin, 'More on Boris Bittker and the Comprehensive Tax Base: The Practicalities of Tax Reform and the ABA's CSTR' *HLR* 81 (1968) p 1016; Boris Bittker, 'Comprehensive Income Taxation: A Response' *HLR* 81 (1968) p 1032.
6. See for example, C T Sandford, *Taxing Personal Wealth* , London, 1971, pp 225-227 which considers five types of capital gains: (1) an increase in share values because the retention and re-investment of profits has increased the real assets of the company; (2) a rise in share prices reflecting the constant capitalisation of large expected income; (3) a rise in value of land because of community development; (4) an increase in asset prices from a fall in interest rates; and (5) a rise in asset prices reflecting a rise in the general price level. See also L H Seltzer, *The Nature and Tax Treatment of Capital Gains and Losses* , Chicago, 1951, pp 83-108.
7. *Harley v Commissioner of Inland Revenue NZLR* (1971) 482, 487 (CA); *Grieve v Commissioner of Inland Revenue TRNZ* 6 (1983) 461, 467, 474 (CA).
8. *Grieve v Commissioner of Inland Revenue TRNZ* 6 (1983) 461 per Richardson J at p 471.
9. The Government has since legislated to incorporate a requirement that for there to be a business, there must be a reasonable prospect of profit.
10. *Hazeldine v Commissioner of Inland Revenue NZLR* (1968) 747; *Cashmere Properties v Commissioner of Inland Revenue ATR* 4 (1974) 523.

11. *Commissioner of Inland Revenue v Walker NZLR* (1963) 339 per North J at p 360.
12. C f *Eunson v Commissioner of Inland Revenue NZLR* (1963) 278 at 280 where Henry J said that the third limb "catches some residue of methods of earning profits which are neither a business nor the realisation of property bought for the purpose of sale". An example of such a method may be a transaction not involving the sale or disposition of an asset but affecting the realisation at a profit; as where a company purchases an asset with a resulting increase in the value of its shares and then sells its shares.
13. *Commissioner of Inland Revenue v Walker NZLR* (1963) 339 per North J at 361.
14. See the cases reviewed in A Alston, 'Taxation of Profits from the Sale of Personal Property ', *Otago Law Review* 5 (1981) p 114.
15. See for example *Eunson v Commissioner of Inland Revenue NZLR* (1963) 278 per Henry J at 280 and *Commissioner of Inland Revenue v Walker NZLR* (1963) 348 per North J at 361.
16. *NZLR* (1963) 348, 361.
17. See for example section 129 (revised assessment where land sold within 10 years of acquisition) and section 204 (life insurance companies).
18. *TRNZ* 7 (1984) 41.
19. Ibid at p 43.
20. G J Harley, 'Structural inequities and concepts of tax avoidance ' *Victoria University Law Review* 13 (1982) 38 at p 40.
21. Bevin op cit 84.
22. Seltzer op cit 4.
23. Henry C Wallich, 'Taxation of Capital Gains in the Light of Recent Economic Developments ' *National Tax Journal* 18 (1967) 133 at 140-141.
24. Robert Officer, 'Capital Gains and Company Taxation' *Australian Tax Forum* 1 (1984) 281 at 282.
25. For discussion on this issue see Bevin op cit chapters 2.7 and 3.2 and *Report of the Task Force on Tax Reform*, Wellington 1982 (*McCaw Report*) Chapter 5.
26. *Report of the Royal Commission on Taxation (Canada)* (Queens Printer, Ottawa, 1966) (hereinafter called the *Carter Commission Report*). *Reform of the Australian Tax System Draft White Paper* (Australian Government Publishing Service, Canberra, June 1985) (*The Draft White Paper*).
27. *Carter Commission Report*, op cit Volume III, Chapter 8, para 10.
28. This was recognised in the *Carter Commission Report*, Vol III, Chapter 8, para 11 cf Richard Krever 'Structural Issues in the Taxation of Capital Gains' *Australian Tax Forum* 1 (1984) at pp 168-173.
29. Krever 172.
30. See 'Particular Problems of Implementing a Capital Gains Tax', section 2, The 'lock-in'.

31. Idem.
32. Ibid, see section 3, 'Illusory gains - the problem of inflation'.
33. See for example Wallich op cit 143-147; Slitor op cit, 67 and Joel Slemrod 'The Effect of Capital Gains Taxation on Year-end Stock Market Behaviour' *National Tax Journal* 35 (1983) p 69.
34. Idem.
35. Income Tax Act 1970 (Canada) section 48.
36. Ibid, section 48(c).
37. Ibid, section 45(1). To the extent that the operation of the provision is dependent on the taxpayer's purpose at the time of acquiring the property it is another area for tax avoidance. See above note 19. The requirement of purpose could be easily deleted without affecting the substance of the provision.
38. Ibid, sections 45(1) and (2).
39. Ibid, section 69(1).
40. Ibid, section 70(5)(a).
41. Ibid, section 70(5)(c).
42. Ibid, section 70 and 73 c f section 74.
43. Ibid, sections 70 and 73. This may be compared with the situation in New Zealand where a person can avoid estate duty by entering into an agreement under section 21 of the Matrimonial Property Act 1976 with his or her spouse to share matrimonial property usually on a 50/50 basis. Estate duty will not be payable on the property that passed to the spouse: see Matrimonial Property Act 1976 section 75A and *Commissioner of Inland Revenue v Curin TRNZ* 6 (1983) 257.
44. Income Tax Assessment Act 1936 as amended by the Income Tax Assessment Amendment (Capital Gains) Act 1986 (The Australian Capital Gains Tax Act) section 160 M8-15.
45. Ibid section 160 M(3).
46. Ibid section 160X.
47. C f above comments at note 28.
48. See for example P G Whiteman, et al *Whiteman and Wheatcroft on Capital Gains Tax* 3rd ed London, Sweet and Maxwell, 1980, pp 2-3; Ross W Parsons 'Capital Gains Taxation - A Lawyer's Perspective' *Australian Tax Forum* 1 (1984) 122 at pp 130-131; and John G Head 'Capital Gains Taxation - An Economist's Perspective' *Australian Tax Forum* 1 (1984) 148 at p 155.
49. *Lowe v Commissioner of Inland Revenue TRNZ* 7 (1984) 41, ef3. See above, note 16.
50. Income Tax Act 1970 (Canada) section 38.
51. Idem.
52. Internal Revenue Code 1954 section 1222.
53. Idem.
54. Idem.

55. Idem.
56. The Australian Capital Gains Tax Act Division 3
57. Reform of the Australian Tax System, statement by the Treasurer The Hon Paul Keating MP September 1985 (Australian Government Publishing Service, Canberra 1985)(The Australian Proposals), p 47.
58. *The Draft White Paper* op cit p 79.
59. Defined in section 54(f) of the Income Tax Act 1970 (Canada) to include (1) any property that is used primarily for the personal use or enjoyment of a taxpayer or any person related to the taxpayer, (2) a debt owing to a taxpayer in respect of the disposition of property that was personal use property, (3) an option to acquire property that would, if acquired be personal use property.
60. Income Tax Act 1970 (Canada) section 38(a).
61. The Australian Capital Gains Tax Act section 160 Z C.
62. Ibid, section 40.
63. The Australian Capital Gains Tax Act section 160 ZZQ.
64. Idem.
65. Ibid, sections 160A and 160L.
66. Ibid, sections 160 ZH(1).
67. Ibid, section 160 ZH (5) and (7).
68. The Australian Proposals p 48.