Capital taxation

Lindsay McKay*

The principal impetus behind the offering of the series of lectures of which this paper is one was the presentation in April 1982 of the report of the Task Force on Tax Reform. I have a very considerable admiration for the quality of that report, and expect that our tax structure will very shortly be the better for it.

Having said that, the topic of this paper nevertheless relates to an area where I think the Committee has faltered and stumbled: namely, its recommendations in relation to capital taxation. My thesis, contrary to the report's recommendations, is that action in the area of capital taxation is indeed needed and that it is needed now.

In the course of elaborating upon that thesis I shall say very little that is new. The arguments in favour of any of the variants of wealth or capital or transfer taxation are well rehearsed, and there is no great novelty that I can add to them. But I do not apologise for restating the case for capital taxation yet again, and nor do I seek your indulgence to retread well-worn ground. For in my judgment the issues involved are of the first rank of importance and the resolution of them is a central imperative if our current tax reform exercise is to be as thorough-going as it must and should be.

Subject to these constraints, let me look first, and briefly, at the Committee's recommendations on what was for many years, at least relatively speaking, one of the most significant forms of capital taxation — namely, the estate duty. The Committee's discussion of this topic is brief. It points out the small, and declining, amount of revenue which has been generated by this levy in recent years, points to some of the advantages of an inheritance tax over an estate duty and then concludes that a study of the national pattern of wealth distribution is required before positive recommendations can be made.

The Committee, in my view, might well be correct in its apparent preference for an inheritance tax over an estate duty, though one is entitled to note in passing that it is somewhat surprising that it gives no real attention to a capital transfer tax, which has decided equity advantages over both.

That aside, however, it is difficult to see the Committee's reluctance to make positive recommendations in this area as justified. The study of wealth distribution

* Professor of Law, Victoria University of Wellington.

it has in mind, and which it regards as a prerequisite to making any firm recommendations, is presumably the same type of investigation as that carried out by the 1975 United Kingdom *Royal Commission on the Distribution of Income and Wealth.*[1] We are entitled to doubt the usefulness of such a study on several grounds. First, while we would all concede that a certain elementary level of information as to existing patterns of wealth distribution is necessary to provide a context for the taking of decisions in relation to the level or rates of estate, or inheritance, or transfer taxes, we already have that available, at least to the level of sophistication required, in the estate-multiplier method as applied to estate duty data. A fully fledged study of the type proposed by the Committee would certainly flesh out the information presently available, but only within a set of boundaries and a range of distributions which we can already establish or of which we are already aware.

And that leads on to my second reservation about the need for the proposed study. The type of detail it is likely to throw up is not in my judgment within the class of information we need to know to make decisions on the issues identified by the Committee, for those issues, which are essentially threshhold issues of principle, are largely independent of and removed from the details of a particular existing pattern of wealth distribution. Consider some of them:

— should the transfer of property on death be a taxable event?
— should the identity of the recipient and her or his relationship with the deceased influence the quantum of tax imposed?
— what prior maintenance or other claims upon the estate have to be recognised before the imposition of duty?
— is the tax essentially a generational tax, so as to justify a full exemption of inter-spousal transfers?
— is the tax to be estate based or inheritance based?
— what is to be the relationship of the tax with the gift duty?
— is the function of a gift duty to buttress the estate tax and prevent its avoidance by lifetime transfers, or is it to facilitate and encourage inter-vivos gifting?
— is taxation on death to be divorced from lifetime transfers or is it to be part of a lifetime and testamentary transfer tax?

These are but some of the issues to be resolved. In my opinion, the resolution of none of them is facilitated by the study of the type proposed by the Committee. For they are at bottom not revenue or economic issues or issues that lend themselves to an empirical response, but rather questions of a policy and social nature. If we abstract the analysis to its most generalised level, our answers owe very little to what is any *actual* pattern of wealth distribution — which is the focus and preoccupation of the Committee — and more to a range of collective perceptions and attitudes on the transfer of wealth from generation to generation. Such has certainly been the approach taken by Parliament in this area in recent years, in that the virtual abolition of the duty for all but the wealthiest decedents which it has recently brought about has been debated firmly, indeed exclusively, on that very basis. One is disappointed that the Committee elected not to debate the estate duty

1 1975, Cmnd. 6171.

in similar terms. Its "we need more information" approach has, I think, by misjudging the real nature of the inquiry, let pass the only meaningful opportunity for a disciplined and informed public debate on the propriety of the radical constrictions of the estate duty brought about by Parliament in recent years.

The result is that a tax accepted by all New Zealand political parties in the first forty years of this century as being in the words of one former Prime Minister, "the fairest and most rational tax of all"[2]; a tax which is largely free of economic distortions; a tax which for many decades of our taxation history has been seen as a central instrument of the tax structure and as vital to the equity of the overall tax mix has been virtually omitted from the proposed remodelled tax structure.

That must I believe inevitably fuel rather than quiet the collective cynicism which prevails in respect of the tax structure, the countering of which the McCaw Committee so properly and necessarily saw as one of its principal aims. Because can we seriously defend the equity of a tax structure which sees the placing of a dollar bet on a race-horse as a taxable event, but not the passing of a fund of hundreds of thousands of dollars on death? Can we seriously defend the gratuitous transfer free of any duties of an income stream of $15,000 a year when the derivation of a similar annual amount by a wage earner is seen to necessitate the imposition of an annual income tax levy of around $4,000? By what definition of assessability and non-assessability can the transfer and receipt of what to the average taxpayer are huge sums of wealth, and which at least from the recipient's standpoint are unearned, justify a zero rate of estate or gift tax when the average wage is taxed at a marginal rate of 48%? How can it be, to take a not uncommon example, that the capital value of a farming property, already reflecting in any event the impact of tax capitalisation of a raft of incentives, grants, special deductions and other preferences, receives the additional preference of passing free or substantially free of tax, when transfers to the average wage earner from his employer are subject to levies of existing proportions? I do not say that the outcome of these questions is necessarily in favour of the imposition of an estate or inheritance tax. But I do respectfully suggest that these questions should, at least, have been asked.

Let me turn now to the main theme of my address — the question of taxes on lifetime capital gains. On this question, as on that of the estate duty, the McCaw Committee says very little. It confesses to certain attractions in the tax, it points to certain weaknesses in it, and it then concludes that for a variety of reasons it does not favour the introduction of capital gains taxation. I find this treatment disappointing, both because of its brevity and also, I concede, because of its conclusion. It seems to me, with respect, that the difficulties and objections to capital gains taxes identified by the Committee are largely illusory and that its negative conclusion is unsupportable. It is my own belief that the case for the imposition of a capital gains tax is overwhelming at the level of principle and that such a tax is capable of quick and ready implementation at the level of practice.

2 Rt. Hon. Sir Joseph Ward, New Zealand Parliamentary debates Vol. 148, 1909: 442.

How does one commence to argue the case for capital gains taxation? From the fact that most jurisdictions broadly comparable with our own possess such a tax? From the virtually unanimous concensus among tax theorists of the desirability of a capital gains tax? From the support afforded capital gains taxation by virtually all Commonwealth Royal Commissions on taxation? If not from these considerations, then perhaps from classic economic theory which denies any distinction between income and capital receipts and would tax capital gains in full as a mere subclass of income. If not from that argument, then perhaps from the standpoint of recipients, and from the consideration that at least in most cases a dollar derived as capital serves to increase the taxable capacity in precisely the same way and to the same extent as a dollar derived on income account. Or perhaps from the related standpoint of horizontal equity, and the notion that those in like positions should be treated alike, or from considerations of vertical equity, and the distortions in that which inevitably arise through the exclusion of significant classes of receipt from assessability. If not from these considerations, then finally from the often purely technical character of the distinction between income and capital receipts, a distinction that while it is an essential part of our tax consciousness is frequently bereft of substance and meaningless in economic terms.

Any of these considerations would, to my own mind, be a sufficient basis for the introduction of a form of capital gains taxation. The last, however, seems to me to have the greatest weight and substance. It is illustrated by, I believe, and in turn it explains, the difficulties the courts have traditionally had in determining between income receipts on the one hand and capital receipts on the other. These difficulties, though they have led to a series of unworkable and for the most part untenable distinctions drawn by the courts, are not of the courts' making. The basic cause of them is, rather, that the line between assessability and non-assessability, between income and capital, makes sense neither in terms of the motivation of taxpayers in generating the receipts — in all cases it is to make as large a profit as possible — nor in terms of the identical increase in economic power once the receipt is derived. In such circumstances it should occasion no surprise that the only consistency in this area is not that of principle but that of the frequency the distinction is exploited for avoidance purposes.

If all of this, or indeed any of this, is so, why then do we not tax capital gains? We can take the Task Force's arguments on this matter as a useful summary of reasons frequently advanced against the imposition of capital gains taxation.

First, the Task Force indicates that capital gains taxes do not produce much revenue. Now, as a matter of fact that must be true. In OECD jurisdictions the average contribution of capital gains taxes to overall revenue is in the order of 1%. Even treating capital gains as ordinary income and taxing them in full on the income scale with no averaging and no allowance for length of holding, it is unlikely that a capital gains tax would yield greater than 3% or at best 4% of total revenue demands.

But to point to the relatively small amount of revenue generated by capital gains taxes seems to me to do no more than to describe a feature of them, not to provide a reason to reject their introduction. The Committee's inference that the

revenue return is too small to warrant the difficulty of establishing them seems to me to be in error on two grounds. The first is that even in the realm of gross government revenue, a one-two percent contribution, of the order of 70-100 million dollars annually, would hardly be unwelcome. The second response is that as the Committee itself recognised in other contexts, the capacity for revenue generation is not the only, or even necessarily the most significant, criterion for the imposition of a tax or for the determination of its details.

Elaborating a little upon this second point, the Income Tax Act 1976 would raise the same amount of revenue as it presently does, from more or less the same taxpayers as it presently does, in more or less the same proportions as it presently does, through a document of around 20 sections of shorter compass than this paper. You do not need the Government Printer's rival to *War and Peace* if revenue generation is your only aim. You do need more than that, however, if you are using the tax Act for other purposes —if you use it for instance, as we do, as one of the most important sources of government expenditure; as a regulator of commercial and corporate practices and as a vital albeit implicit manifestation of societal values and imperatives. I need not elaborate upon the myriad of occasions within the present Act in which the latter phenomenon is present. It is sufficient to say, I think, that if it is felt that the equity of the overall structure requires a capital gains tax, then the great bulk of the Income Tax Act 1976 is testament to the proposition that its limited revenue significance is no grounds for failing to recognise that requirement.

The Task Force's second argument against the introduction of a capital gains tax would have it that the taxation of capital gains in times of high inflation would create an inequity in the tax structure, the inequity being the taxation of nominal rather than real gains. It is very difficult to give much weight to this argument, however, for the fact is of course, and the report is at pains in other areas to point this out, that other taxable receipts are not presently indexed for inflation and are almost certainly not going to be so indexed in the foreseeable future. Rather, the inflation element in them is taxed at progressively higher rates. I would not ordinarily argue that one unsatisfactory consequence justifies another. But I do say that to hold out the taxing of inflation gains as an objection to the imposition of a capital gains tax seems impossibly selective in present economic circumstances. The real disposable income ratios illustrate, if we need illustrations beyond our general experience, that the effect of fiscal drag has been to bring about for many a reduction in real standards of living. That is a phenomenon which is with us now. It is likely to continue and indeed to be exacerbated by the July 1982 wage freeze. It is in a sense an *ongoing* inequity which provided more than any other consideration the groundswell which led to Mr McCaw's deliberations. To taxpayers subject to it it must seem the height of selectivity to see a measure designed to increase the degree of equity within the overall tax structure — the imposition of a capital gains tax — given away on the basis of the unfairness of taxing inflation gains. It would be preferable, I believe, to recognise the force of the equity arguments in favour of the taxation of capital gains by putting such a tax in place and then making whatever allowances — through the use of a

graduated scale based on length of holding, for instance — were regarded as minimally necessary to counter the inflationary element. But I would make one comment about the use of such a device for this purpose: as long as other taxable receipts include an inflation element of significant proportions and are taxed on progressive scales, capital gains reliefs of the character suggested must be sparingly applied. The greater the generosity here the greater the inequity in the structure as a whole.

The Task Force next argues that no appreciable loss of equity is occasioned by the absence of a capital gains tax, on account of the relative scarcity of assessable capital gains. It points out first, that any capital gains tax would exempt gains on the taxpayer's residence so they should be excluded. It then says that the tax would have little impact in the area of company equities, since these investments have recently been characterised by real, or inflation adjusted, losses rather than gains. And, finally, while it concedes that real estate transactions, particularly involving rural land, have led to real gains in recent times it suggests in respect of them that at least many of those gains are the result of deliberate government policy and on that account not a fit subject for capital gains tax. Its implicit conclusion is that there are in fact few capital gains which are escaping taxation and those that do escape are deliberately excluded for good reason.

A number of responses may be made to that line of reasoning. First, in relation to its treatment of equities. The report is correct in suggesting that, judged by aggregate indices, there have been real losses, rather than real gains, in this context in recent years. That establishes that we are unlikely to get fat on the yield of capital gains tax from this source. But as in the context of my earlier discussion of revenue yield generally, it does not establish a case for failing to impose a capital gains tax on those gains which do arise. Estate duty exists, notwithstanding that few now die with estates at taxable levels. Gift duty exists, notwithstanding that few taxpayers will ever make a taxable gift. And of course, the income tax exists, notwithstanding that one half of the community either break even and pay no income tax or run at a loss. Relative scarcity of equity gains, then, is no real argument at all.

The Committee is in error too, I think, in seeing other features of gains and losses on the realisation of equities as constituting grounds for not imposing capital gains taxation. The Committee points out, for instance, that there is often a degree of flexibility in the timing of equity realisations. It points out too that it is possible for taxpayers holding appreciated equities to set off gains realised upon their sale by counterbalancing losses on other investments. Both these and related phenomena are indeed features of the operation of a capital gains tax upon equity gains, and the Committee is correct in identifying them as such. But it is in my respectful submission quite in error in so far as it sees them as reasons for not imposing a capital gains tax. One must accept, I think, that capital gains taxation, like most forms of property taxation, has always been subject to those phenomena — that there is often a greater capacity to minimise the tax levy by postponement of realisation and the like. One can react to that flexibility, to that element of semi-optionality, in a variety of ways. One may either try to regulate it to the extent that one can — and I believe that is in fact substantial — or simply live with it.

But it seems a decidedly unusual response to react to the existence of these preferences by conferring the further and infinitely greater preference represented by the withdrawal of the tax altogether.

Moving now to the Task Force's treatment of real estate gains. As I noted earlier the Committee takes the view that while there have been real, as opposed to illusory, gains in this area over recent years, there are certain features of those gains which suggest that they would not be the fit subject of capital gains taxation. It says, for instance, that some of the capital gains in question are the product of tax capitalisation of desirable, or at least deliberate, government support measures, and that "it would be inappropriate to tax benefits accruing as to do so would undermine the value of the incentive originally offered".[3]

With respect, that cannot be right, at least as a general proposition. The class of incentives in question, almost without exception, is intended to promote increased production and carrying or yielding capacity. Their direct impact, certainly in intention and one imagines in practice as well, is on income account through the generation of income tax shelter status for virtually all classes of farming activities. The "incentive originally offered" which the Committee sees it as being essential to preserve, at least as far as government's pronouncements go, has never been directly or indirectly intended to increase capital values. Tax capitalisation with the result of higher capital value is in fact a product, and one suspects an embarrassing one, of income tax related incentives. But its achievement has never been the policy itself. It would be the height of irrationality to so regard it. In such circumstances, the imposition of a capital gains tax would not be in the slightest "inappropriate" since its principal function would be to subject the windfall gain to taxation and as a result to recapture the unintended benefit. It is difficult to see any frustration of government policy in such a course.

Finally, the Task Force calls in aid section 67 of the Income Tax Act 1976, which it describes as a "wide provision" taxing profits "akin to capital gains", the presence of which "further reduces the need for a specific capital gains tax".[4] One must acknowledge at least a limited validity in this argument. Section 67 does indeed include a small number of gains of a broadly "capital" rather than income character within the income net. But beyond the point of that acknowledgement, the Task Force's argument is a little hard to follow. To me at least, rather than providing an argument against the need for a capital gains tax, the force of the section is rather in favour of the case for such a tax.

Let me elaborate upon that a little. The thrust of section 67 is to tax as ordinary income a number of gains which would not be assessable as income under other provisions or under established notions of "income". The extension of the boundaries of income which it involves has, at least as far as one can judge, been accepted as both sensible and defensible. Yet, it is very difficult to see any really fundamental distinctions between some of the occasions which section 67 treats as suitable occasions for the imposition of a form of capital gains tax, and

3 *Report of the Task Force on Tax Reform* (Government Printer, Wellington, 1982) 234.
4 Idem.

others, not listed, where no form of tax at all is imposed. My point, in other words, is that the logic behind section 67 may well be seen to be in favour of the general taxability of capital gains.

Take the first of the taxable events specified in section 67(4)(a) as an illustration of this. That paragraph provides:

For the purposes of section 65(2)(f) of this Act the assessable income of any taxpayer shall be deemed to include —

(a) All profits or gains derived from the sale or other disposition of any land if the land was acquired for the purpose or intention, or for purposes or intentions, including the purpose or intention, of selling or otherwise disposing of it.

Few objections can or would be raised to the taxable event described in this paragraph. In so far as we see that it does indeed involve an element of extension of the ordinary boundaries of "income", we are not too concerned as we tend, as part of our general tax awareness, to see that a purchase with the intention of resale is in some senses "different" from a purchase without that intention and as a fitter subject of tax on that account. But in my view that response is one of habit, rather than logic. Because, what after all is the difference between a gain arising from the sale of property purchased with the intention of re-sale, and a gain derived from property purchased with a different intention, such as investment, or purchased with no fixed intention at all? Certainly, not because purchase with the intention of resale brands the enterprise as a profit making venture, for purchase with virtually any intention other than for use as a domestic residence is also motivated by that intention. Certainly not the purposive character of the enterprise, because that too is shared in common with other intentions accompanying other purchases. Why then should not an intention to make a profit in and of itself be enough ground for taxability? Why, more generally, should any particular intention at all be required? In the final analysis, the specification of a particular motivating purpose as a precondition to assessability does little more than render the tax imposed by section 67(4)(a) an elective or optional one to the glib and well advised taxpayer. That, rather than any fundamental difference at the level of concept, is all that is preserved by the paragraph.

Analogous observations seem to me to be justifiable if we go to the other limbs of section 67. Under section 67(4)(d), for instance, gains on land sales within ten years are taxable if at least 20% of the gain arises from re-zoning or related causes. In many ways that is a classic capital gains provision. But it inevitably raises questions. Why a maximum ten year holding period as a condition of assessability? Why a minimum 20% gain from re-zoning or the like? Why should a gain, be it windfall or otherwise, be regarded as a fit subject for taxation if it arises within a seemingly arbitrarily-selected time period and not if it arises after it? Not because of the taxpayer's intention, because that is irrelevant. Nor because of any element of windfall, or similarity to business activity, or speculation, or any other basis which is often used to justify the extension of the income definition, because none of those is relevant either. And certainly not because of considerations of taxable capacity or equity. My objection here is not at all against the drawing of lines as such: that seems to me to be frequently a necessary exercise, and one that we should not be deterred from by the often inevitable similarity of cases on either

side of the line. My objection is rather at the drawing of lines which do not seem to make sense, in circumstances where logic suggests a continuum and a consistency of treatment.

In summary then, section 67 of the Act does seem to me to be a significant provision. But its significance lies, I think, not in indicating the lack of need for a general capital tax as suggested by the Committee, but in the complete reverse.

Those are the main arguments raised by the McCaw Committee against the capital gains tax. Time constraints forbid any discussion of a number of other arguments frequently levelled against the tax. Some of these do not warrant serious discussion, being in essence no more than self-interest disguised as misleading slogans and predictions of catastrophe. Others of them are less objections to capital gains taxation as such and more statements of issues which must be resolved before the implementation of such a tax, such as the treatment of averaging, the deductibility of capital losses, the notional realisation of gains on death and the like. If I pass by the arguments in this second class as well, it is not because I do not regard them as significant, but because I have chosen to spend the time available to me in attempting to put the case for capital gains at the level of general principle rather than to concern myself with the details of the implementation of a particular form of capital gains taxation. But I do say this: I have no doubt at all that we can, as have numerous other jurisdictions, resolve these issues quite satisfactorily.

I have made no attempt throughout my discussion to disguise either my own commitment to a capital gains tax or my firm belief that the adoption of such a tax is a central imperative of any meaningful tax reform. In being as explicit on these questions as I have, I do of course run the risk of being said to have stepped outside the neutrality which is the commentator's role and of permitting my own preferences and values to intrude. Yet I do not apologise for that. For my belief is that for all its appearance of neutrality, of well-ordered logicality, of Olympian removal, the Income Tax Act 1976 is from start to finish little more than a collection of preferences and values and that on matters crucial to the distribution of the tax burden, it is not in the slightest neutral. It is, rather, the product of pressure, of sectional self-interest and of political balancing. It has as a result something of the character of a score-card of winners and losers in a national power-play. In that context, the fact that we do not presently tax capital gains is in large measure because it serves certain classes of taxpayers and those who represent their interests not to levy such a tax. Unless we do keep this sense of perspective upon the debate, we are likely I think to end up debating false and misleading issues. The real issue in the capital gains inquiry is whether a tax preference, the availability of which rises as a factor of rises in income, which has a capacity to significantly distort an otherwise equitable distribution of tax burdens, should be permitted.