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To: Minister of Finance

AIDE MEMOIRE: LONG-PERIOD BRIGHTLINE TESTS

Length of test

The subgroup note and additional revenue raisers note received by Ministers yesterday discussed options for a 3 and 5 year brightline test, and whether it would be possible to introduce a brightline test on Budget Day.

Treasury recommended that if a bright-line test was introduced on Budget night that it be limited to residential property disposals within a minimum of a 5 year period; that loss ring-fencing apply, and that the changes be grandfathered (i.e. apply only to property that is acquired after Budget day). Treasury also recommended that application to other real property and equities be considered and consulted on after the Budget, with implementation (if desired) from 1 April 2011.

We understand Inland Revenue opposes a bright line test in general due to the arbitrariness of the bright line period and the behavioural distortions caused by taxpayers deferring sales in order to avoid the tax.

Treasury favours a brightline test with a reasonably long period (5 years minimum) for the same reasons it favours a capital gains tax – it would broaden the tax base and improve the neutrality of the tax system resulting in a more efficient allocation of savings and investment. It will also reduce some of the uncertainty in applying the current subjective “intention” test for determining if disposals are on revenue account. Treasury agrees with Inland Revenue that it has some downsides in terms of behavioural distortions caused by taxpayers deferring sales and considers that a comprehensive capital gains tax is superior to a bright line test for that reason. However, in the absence of capital gains tax, Treasury considers that a bright line test with a minimum period of 5 years is better than the status quo.

Treasury considers however, that a longer brightline test is also worth investigating after the Budget; and that consideration should also be given to whether to extend the scope of the test to include other property (excluding owner-occupied property) and equities.

A longer test would apply to a greater number of properties, and would decrease behavioural responses to the test as avoiding the test through delay is less viable. Due to the increased property subject to the test, and the decrease in behavioural changes, this would increase projected revenues. A longer test could enable the test to be set as a “safe harbour” (i.e. that properties sold after the period could be treated as exempt from the rules) rather than as an addition to the existing property sales rules, increasing certainty around tax treatment.

Scope of property subject to the test

Increasing the scope of the property from residential investment property to include other business and investment property would ensure that these assets are treated in a similar manner for tax purposes. Extending the scope to equities would remove opportunities to game a brightline test that applied only to real property. Ideally, the rule should apply to all business and investment assets. In practice, real property and equities are the only major categories of property that are likely to appreciate and therefore be affected by the rule.

Taxing gains from selling commercial and industrial property would allow us to be more relaxed about allowing depreciation on those assets, as any over-depreciation would be recovered on sale.[1]

Taxing shares would impact managed funds, and reverse one aspect of the PIE reform which removed revenue account treatment for managed funds. However, the reason for this was to reduce the difference in taxing share gains made directly (largely on capital account) and taxing share gains made through managed funds. If individual as well as managed funds are both taxable on share gains, then they would both be treated the same.

In practice, PIEs would probably have to recognise gains and losses on changes in value on accrual because they calculate tax on behalf of their investors on a daily basis. This obviously raises practical issues which is one reason why we recommend that the bright-line test not apply to shares on budget night legislation, as we would need to consult with funds and others before making final recommendations.

Revenue estimates

Estimated revenue from a 5 or 10 year brightline test are:

5 year test

$ million	**2010/11**	**2011/12**	**2012/13**	**2013/14**	**2020/21**	**2030/31**
Grandfathered						
Residential investment property	0	2	12	30	84	116
Other real property	0	0	2	6	25	66
Equities	0	225	255	280	336	434
Total	**0**	**227**	**269**	**316**	**445**	**616**
Not grandfathered						
Residential investment property	0	71	73	75	90	116
Other real property	0	40	41	42	51	66
Equities	0	265	275	280	336	434
Total	**0**	**376**	**389**	**397**	**477**	**616**

[1] Although current law requires depreciation "recovery" on sale, in practice this is largely ineffective as applied to buildings because taxpayers often over-allocate sales proceeds to land (which is not taxed) and under-allocate sales proceeds to buildings where the recovery applies. Taxing all gains would remove this ability.

10 year test

$ million	2010/11	2011/12	2012/13	2013/14	2020/21	2030/31
Grandfathered						
Residential investment property	0	2	12	30	300	412
Other real property	0	0	2	6	97	250
Equities	0	225	255	280	336	434
Total	**0**	**227**	**269**	**316**	**733**	**1096**
Not grandfathered						
Residential investment property	0	253	260	266	319	412
Other real property	0	154	158	162	193	250
Equities	0	265	275	280	336	434
Total	**0**	**672**	**692**	**708**	**848**	**1096**

The estimates for residential and real property are based on QVNZ data about the length of time properties were held before sale; assumptions about turnover rates and appreciation (a conservative real growth rate was assumed - this is lower than the average real growth rate over the longest available period); and average tax rates (these were the same tax rates used for the other base broadening options; and are based on the current base scenario with a 30% corporate rate). We have assumed a lower rate of appreciation for real property than the long-term average that was used for costing a capital gains tax because we consider a lower growth rate in the near term is likely due to the recent housing bubble and collapse. The revenue estimates for equities is based largely on reversing a costing used for the implementation of the PIE regime.

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