Date: 23 March 2010 SH-13-5

To: Minister of Finance

AIDE MEMOIRE: SUPPLEMENTARY BRIGHTLINE TEST NOTE

At the subgroup meeting on 22 March, a number of points were raised about the brightline test. The following sets out Treasury's thoughts on the brightline test more completely:

Why a brightline test? – current capital revenue boundary tests

The current tax law contains a capital/revenue distinction that applies to potential taxation of gains (and deductions of losses) on sales. There is no real economic principle behind the distinction, it based on historic common law concepts of revenue and capital that applied to trust law, which courts have since interpreted as applying to concepts of income for income tax purposes. As the distinction has evolved, it can roughly be said that revenue gains and losses are more those realised when selling is done as part of the operation of a business (trading stock is an obvious example of this), and capital gains and losses are more those that are sporadic, infrequent, and not done systematically as a way of earning income. One of the tests that has come out of this is the "intention" test – if property was purchased with the intention of reselling it, the gain is taxable. In practice, this has been difficult to apply because it is difficult to prove intention other than having the taxpayer admit it. Further, if property is sold for a loss, the taxpayer may say it was bought with the intention of resale, meaning in effect the test has an asymmetric effect with losses intentionally being brought into revenue account but not gains.

Treasury prefers a comprehensive capital gains tax as it is more economically principled and promotes efficiency more than the current capital/revenue boundary. However, we understand that there will be no CGT as part of the current tax reform. Nevertheless, we think improvements can be made to the current boundary to improve certainty and capture more gains as taxable. This would be that for certain categories of property (such as residential investment property), sales made before the brightline period would be on revenue account, sales made after the brightline period would be on capital account. For property subject to the brightline test, the brightline test would replace the intention test so the intention test would no longer be relevant for those types of properties.

Property subject to the test

Property subject to the test could range from all property that would potentially be subject to a CGT if we had one, to a narrower category if Ministers prefer that it be more targeted. A range of properties that it could apply to could be (from broadest to narrowest):

- All business and investment property;
- All business and investment real property and intangible property (including shares);
- All business and investment real property; and
- All residential rental property

Treasury's preference would be the broadest category. However, we consider any of the above options would be an improvement on the status quo. If anything is to be legislated for the budget, we consider only residential rental property should be included in budget legislation, with post-budget consultation on any broader category of property.

Length of test

Any brightline period is inherently arbitrary. We consider a 5 year test would be the minimum that could apply before the advantages would outweigh the disadvantages. There is currently a 10 year brightline test that applies to property dealers and developers,[1] so this period could be used as a precedent to apply to other real property sales such as residential investment property.

Transition

If a brightline test is introduced, Treasury's preference would be to introduce a grandfathered test. A grandfathered test would not apply to existing investment properties. Rental properties, baches, or second properties currently held would not be affected. Properties bought after the test is announced (and not subject to a binding to contract to purchase that was in effect before the announcement) would be bought subject to the knowledge that the brightline test will apply. Treasury therefore does not consider that application of the test to these properties would create fairness concerns.

Avoidance

A brightline test that applied only to real property would be subject to potential avoidance. Property could be held through companies instead of directly, and the shares sold instead of the property. If the same brightline test applied to shares, this would not be an issue. However, if shares are not included, some anti-avoidance rule would be necessary. Due to time constraints, budget night legislation would not include this, but consideration of an appropriate rule would be done in post-budget consultation.

Losses

A brightline test could be subject to manipulation – loss making properties may be sold before the brightline in order to be deductible, with gains sold after the brightline period in order not to be taxable. In order to manage this, "brightline" losses would be deductible only against "brightline" gains. Such loss ringfencing rules are common in capital gains taxes. Currently, capital losses are not deductible at all.

Other Countries

The following OECD countries have a brightline test where property sold before the brightline date are taxed at ordinary rates, property sold after the brightline date are exempt from tax.

Country	Property	Brightline Period
Austria	Most real property	10 years
	Principal residence	2 years
Belgium	Land	8 years
	Developed property	5 years
Germany	Real property	10 years
	Shares	1 year
Italy	Real property	5 years

[1] Sections CB 9 to CB 12 of the Income Tax Act 2007.

Revenue

See accompanying aide memoire for an estimate of revenue impact of a brightline test.

Process

There are broadly two possible approaches to adopting the brightline test:

- A two-step approach that would include budget night legislation covering residential rental property, followed by post-budget consultation on refinement or expansion; or
- A budget announcement of an intention to have a test, followed by post-budget consultation for designing the regime.

The second approach has advantages in ensuring the regime is reasonably well designed before implementing. However the first approach has the advantage of ensuring that the fiscal consequences of the budget night legislation could be included in the budget fiscal updates and also ensures the regime applies to residential investment property quickly. The parameters of potential budget legislation are included in the Annex.

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Annex – Terms of Potential Budget Legislation

Revenue account property includes:

- Property sold no more than x years after acquisition;
- That was acquired after 20 May 2010 (and not acquired subject to a binding contract in effect on or before 20 May 2010);
- That is not the taxpayer's principal residence;
- That is or was rented or leased to a person where the supply was an exempt supply under section 14(1)(c) of the Goods and Services Tax Act 1985.

Revenue account property does not include property described as above except that it was sold after x years;

Losses incurred are not deductible except to the extent of gains on revenue account property as defined above;

Losses not deducted in the year are deemed to be new losses of the same type incurred in the next income year.