Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Property-related tax issues

Date:	22 February 2010	**Priority:**	High
Security Level:		**Report No:**	T2010/225 PAD2010/28

Action sought

	Action Sought	**Deadline**
Minister of Finance	**Agree** to recommendations	1 March 2010
Minister of Revenue	**Agree** to recommendations	1 March 2010

Contact for telephone discussion (if required)

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22 February 2010

Minister of Finance
Minister of Revenue

Property-related tax issues

Executive summary

Ministers are currently considering a number of options that could form part of a tax reform package (T2010/36, PAD2010/02 refers). This report presents three property-related tax issues for your consideration. These matters relate to loss attributing qualifying companies (LAQCs), the ring-fencing of rental property losses, and the capital/revenue boundary.

Key issues to be addressed

Officials consider that there are significant problems arising because losses from LAQCs can be passed through to shareholders and deducted at their marginal rates, whereas profits are taxed at the company rate. These problems will arise as long as the top personal rate is higher than the company rate. They are best fixed by moving LAQCs to a tax treatment that is consistent with limited partnerships, which involves full flow-through of both profits and losses to shareholders. Ministers are asked to approve this change.

Ring fencing would be a way of attempting to prevent losses on property being used to offset tax on other income. While this move would raise some additional revenue, there are a number of practical difficulties. Ministers are asked to decide whether any further work should be undertaken on this issue.

A bright-line test could be brought in to clarify when gains on assets such as shares or property are taxable. A possible approach would be to tax all gains when assets are sold within a fixed period, such as two years. Ministers are asked to decide whether any further work should take place on this idea.

Loss attributing qualifying companies

Since their introduction in 1992, loss attributing qualifying companies have become a popular business form in New Zealand. From 2000 to 2008, the number of LAQCs grew from 39,211 to 132,308 (growth of 237 percent). In the same period, the total value of LAQC tax losses grew from $468 million to $2.294 billion (growth of 390 percent).

LAQCs are commonly used for investments in forestry and rental properties. However, the current use of LAQCs is wider than the original policy intent. They have been the vehicle of choice in many mass-marketed tax avoidance schemes.

There are significant problems with the current LAQC rules. The disparity between the top individual tax rate (38 percent) and the company rate (30 percent) leads to tax base integrity issues. Profits are taxed at the company rate, but any losses can be allowed as a deduction at the shareholder's marginal rate. Secondly, an LAQC shareholder can deduct losses in excess of their equity in the LAQC, so the amount of losses may not be commensurate with the level of financial risk that the shareholder faces. A loophole in the LAQC rules allows shareholders to claim losses and then avoid personal liability for the company's tax by revoking LAQC status before remission income arises.[1]

To address these issues, officials recommend making LAQCs full flow-through for income tax purposes, similar to limited partnerships. Instead of only losses flowing through to shareholders, both the LAQC's income and losses will be passed through in the year they occur. A loss limitation rule would allow taxpayers to offset, for tax purposes, only those net tax losses they have actually borne (that is, the same tax rules applying to limited partners would apply to LAQC shareholders).

Alternatively, the qualifying company (QC) and LAQC regimes could be removed. In the absence of any further changes, this would effectively result in standard company tax treatment. However, this approach would not be consistent with the original policy intent of approximating a partnership treatment, so officials do not recommend this option.

An announcement on either of the potential reform options could be made as part of Budget 2010. Officials could subsequently release an issues paper on the proposals. The final reforms could be included in a tax bill to be introduced later this year and could apply for income years commencing on or after 1 April 2011.

The revenue implications of the proposals would depend on what tax rules replaced them, the transitional relief provided (if any), and the reforms adopted in the Budget 2010 tax reform package. Officials' preferred option to allow full flow-through treatment is estimated to increase revenue by up to $55 million per annum. Addressing the remission income loophole would increase revenue by upwards of $7 million per annum.

Ring-fencing of rental property losses

Under current law, a loss arising from a rental property investment is able to be offset against the other income of the taxpayer. This reduces the tax payable on any other income earned.

The proposal to ring-fence rental property losses would limit the offset of such losses in any given year to the net income earned from rental property investments. A number of OECD countries have some degree of loss ring-fencing for passive investments.

Ring-fencing losses may produce a marginal shift of investment into other investment assets and help to offset other distortions. This could result in some downward pressure on house

[1] Remission income includes an amount of debt that has been forgiven to a debtor.

prices by reducing demand from highly geared investors (although other OECD countries with loss ring-fencing rules have still experienced large property cycles).

As is the case with any tax measure that reduces the tax benefits of an investment, loss ring-fencing is likely to put upward pressure on rents and, at least initially, downwards pressure on house prices. However, Treasury modelling suggests that these effects are likely to be modest.

Introducing loss ring-fencing would create distortions vis-à-vis other types of investment and whether to invest through debt or equity. It should also be borne in mind that gearing is not the underlying problem. The underlying problem is that an investor is only being taxed on part of the economic return from housing investment. More specifically, the taxpayer is able to claim full deductions for expenditures incurred in respect of the rental property investment, while only being taxed on the rental income and not the capital gain. However, quarantining losses does not counter this problem effectively.

There are a number of issues around the practicality of loss quarantining. It may be difficult, for example, to prevent taxpayers structuring around ring-fencing rules due to the fungibility of money and the difficulty in tracing and matching borrowing to particular investments. Past rules in this area were relatively easy to plan around. There are boundary issues such as how to define rental housing and how to treat mixed-use properties. There are also transitional issues around how to deal with existing properties.

Limiting the ability to offset rental losses against other income will be fiscally positive. The actual revenue gain will depend on other Budget initiatives, for example, denial of building depreciation (which may eliminate some losses) and tax rate changes; any transitional rules regarding existing properties; and the "water-tightness" of the rules. Depending on these factors, the static revenue estimates range from $200 million to $300 million per annum after five years. Behavioural changes will, however, result in lower revenue gains. It is a matter of judgement how large this reduction in revenue gain will be.

Ministers are asked to indicate whether they would like officials to undertake further work on the ring-fencing of losses. Inland Revenue considers that the disadvantages of ring-fencing outweigh the advantages, although Treasury considers that additional work may be worthy of further consideration after the Budget. Officials do not consider that robust loss ring-fencing rules could be developed in time for Budget night enactment.

If you indicate that further work should be undertaken, officials suggest that an announcement to that effect be made as part of Budget 2010.

Capital/revenue boundary

The distinction between capital and revenue has considerable practical significance within the tax system. This is particularly so given the absence of a general capital gains tax in New Zealand. In very general terms, the distinction is between flows of income (revenue) and one-off payments (capital).

For most forms of personal property, two statutory tests are relevant. The purpose test deems an amount to be income if the property was acquired for the purpose of sale or disposal. The

business test deems an amount to be income if an individual is in the business of dealing in property of that kind. For land, including buildings and other improvements, the statutory provisions are more complex. Amounts from disposals can be treated as income in a range of circumstances. Owner-occupied residential property is generally not taxed, but may be for a person that has established a regular pattern of buying and selling the properties in which they reside.

The subjective nature of these rules can lead to uncertainty about exactly where the boundary between capital and revenue falls in particular cases. These boundary issues mean complexity and compliance costs for taxpayers, and may create opportunities for tax planning. The rules can also create distortions and inefficiencies, and may discourage equity investment in smaller or riskier firms.

The question is whether a "bright line" test, making it easier to distinguish revenue from capital, would help to address some of these problems. One option would be a time-based test, whereby an amount derived from disposing of an item of property would be treated as taxable income if the property had been owned for less than a specified period. This would act as a rough proxy for determining whether an asset had been acquired for the purpose or with the intention of disposal. It would remove some ambiguity from the tax system, but would be rather arbitrary and would create strong lock-in effects. Treasury and Inland Revenue do not consider that a short time-based test (such as two years) would be desirable. Treasury considers that a longer time-based test such as ten years may warrant further consideration, but Inland Revenue considers this would raise much the same issues as a general capital gains tax.

If you wish to pursue this idea, officials suggest making an announcement as part of Budget 2010 that further work will be undertaken in consultation with stakeholders.

Recommended action

We recommend that you:

Loss attributing qualifying companies

(a) **Note** that the current LAQCs rules cause problems with the integrity of the tax base.

Noted Noted

(b) **EITHER**

Option 1 – Full flow-through treatment for tax purposes (officials' preference)

(i) **Agree** to replace the current QC and LAQC rules with full flow-through treatment for income tax purposes whereby both income and losses are passed on to shareholders, similar to the limited partnership rules.

Agreed / Not agreed Agreed / Not agreed

And

(ii) **Agree** to announce this measure as part of Budget 2010, to be followed by an issues paper for public consultation on the implementation of the changes, and then inclusion in a tax bill to be introduced later this year.

Agreed / Not agreed Agreed / Not agreed

OR

Option 2 – Removal of QC and LAQC rules, company tax treatment

(iii) **Agree** to remove the current QC and LAQC rules and apply the standard company tax rules.

Agreed / Not agreed Agreed / Not agreed

Ring-fencing of rental property losses

(c) **Note** that Inland Revenue considers that the disadvantages of loss ring-fencing outweigh the advantages, and that Treasury considers that further work may be worthy of additional consideration after the Budget.

Noted Noted

(d) **Indicate** whether you would like officials to undertake further work after the Budget on the ring-fencing of losses from rental property.

Yes / No Yes / No

(e) **Agree**, if you decide on officials undertaking further work on loss ring-fencing, to an announcement to this effect being in Budget 2010.

Agreed / Not agreed Agreed / Not agreed

Capital/revenue boundary

(f) **Note** that the subjective nature of the capital/revenue boundary can cause problems for both taxpayers and Inland Revenue, including creating distortions and inefficiencies.

Noted Noted

(g) **Note** that Treasury considers that a time-based test to clarify the capital/revenue boundary may warrant further consideration if the period were sufficiently long, and that Inland Revenue considers that a lengthy time-based test would raise much the same issues as a general capital gains tax.

Noted Noted

(h) **Indicate** whether you would like officials to undertake further work after the Budget on a time-based test to clarify the capital/revenue boundary.

Yes / No Yes / No

(i) **Agree**, if you decide on officials undertaking further work on a time-based test to clarify the capital/revenue boundary, to an announcement to this effect being made in Budget 2010.

Agreed / Not agreed Agreed / Not agreed

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Background

1. Ministers have agreed to further work being done on several property-relaxed tax issues for a potential Budget night announcement. It was agreed that these issues would be progressed and reported on in February 2010 (T2010/73, PAD2010/8 refers).

2. Therefore, this report discusses issues relating to loss attributing qualifying companies (LAQCs), the ring-fencing of rental property losses, and the capital/revenue boundary. It also proposes some options for your consideration.

Loss attributing qualifying companies

3. This section of the report outlines the issues around the use of LAQCs and presents possible options for reform, in particular, making qualifying companies and LAQCs full flow-through entities for income tax purposes, or repealing the regimes entirely.

Background

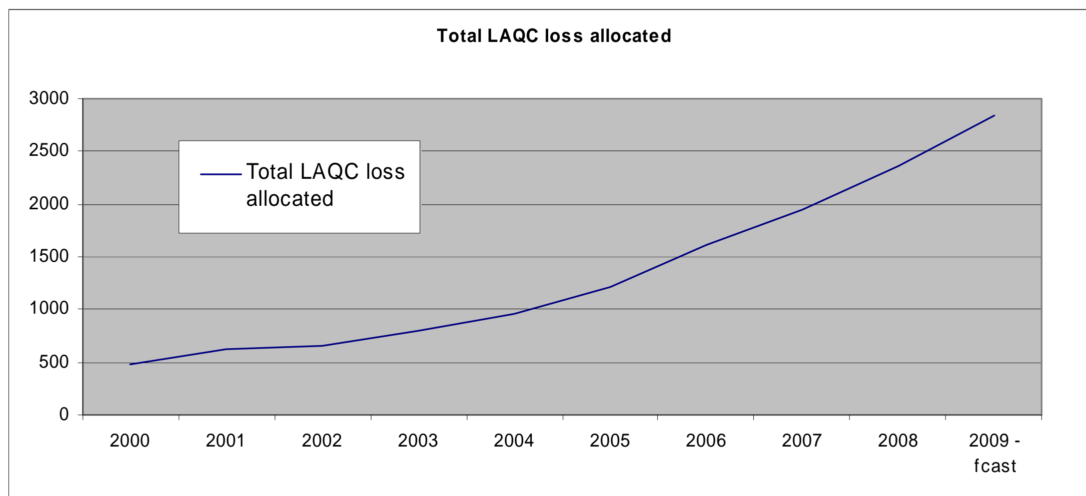
4. The QC elective regime was introduced in 1992 after a review of the tax system by the Valabh Committee. At that time the company tax rate and top personal marginal tax rate were aligned. QCs are closely-held New Zealand resident companies. The original aim of the QC rules was to provide shareholders of closely-held companies a form of partnership treatment for income tax purposes, while maintaining the corporate protections afforded under general law (such as a separate legal entity status and limited liability). Under the QC regime, income is initially assessed at the company level. However, on election to be an QC, the shareholders agree to be personally liable for their share of the QC's income tax liability that is not met.

5. Dividends paid out by QCs are taxable only to the extent that imputation credits are available. To the extent that a QC has no imputation credits, any dividends paid out are tax-free. As a result, shareholders can have tax-free access to the company's capital gains without having to wind up the company.

6. The LAQC rules are a subset of the QC rules. A QC must satisfy additional criteria to be an LAQC. Like QCs, LAQCs have the benefits of corporate ownership, as noted above, and income is also initially assessable at the company level. Unlike QCs however, an LAQC's net losses are allocated to shareholders in proportion to their effective interest in the LAQC. A loss will either be allowed as a deduction from the shareholder's annual gross income or be carried forward.

7. Since their introduction, LAQCs have become a popular business form in New Zealand. From 2000 to 2008, the number of LAQCs grew from 39,211 to 132,308 (growth of 237 percent). In the same period, the total value of LAQC tax losses grew from $468 million to $2.294 billion (growth of 390 percent). In 2009, approximately 95 percent of QCs were registered as LAQCs (164,000 of 172,000).

8. The graph below illustrates the rapid growth in LAQC losses being allocated to shareholders.



9. In the discussion document *General and limited partnerships –proposed tax changes*, released in June 2006, it was noted that the proposed loss limitation rules for limited partners could be circumvented by using LAQCs. The limited partnership rules, which came into force in 2008, also raise the issue of whether it is necessary to retain similar tax treatment offered by the LAQC rules.

LAQCs in use

10. LAQCs are typically used for situations where tax losses are expected, as they allow for losses to be passed through to shareholders to reduce an individual's personal tax liability. Consequently, LAQCs are commonly used for start-up companies where early losses are expected. However, the current use of LAQCs is wider than the original policy intent.

11. LAQCs are commonly used for investments in forestry and rental properties. For the 2008 income year, $800 million of LAQC losses were attributable to the rental property sector. LAQCs account for approximately 50 percent of total rental losses. However, LAQCs are not the only mechanism that allow for tax losses from investments to be offset against the owner's other income. Investments can also be held by a partnership, or simply be held in an individual's own name. In general, the use of LAQCs does not increase the amount of losses available from a genuine rental venture.

12. LAQCs have been used in many high profile tax avoidance cases. In particular, they have been the vehicle of choice in a number of mass-marketed tax avoidance schemes. LAQCs allow people to receive the tax benefit from a tax avoidance arrangement (typically a deduction/loss) while personally staying one step removed, which reduces their financial exposure (because the LAQC is a separate legal entity with limited liability).

13. In some cases, individuals have sold their home to an LAQC, then rented the property back to themselves at a market rate and claimed tax deductions for expenditure on the property (which otherwise would be considered private expenses). Inland Revenue's view, supported by a Taxation Review Authority decision, is that this is a tax-avoidance arrangement.

14. LAQCs can also be used to defeat the disposal provisions under the partnership rules. For example, an individual can invest in forestry through an LAQC and sell the shares in it for a non-taxable gain, instead of investing in a forestry partnership and being taxed on any gain on disposal of their partnership interest.

Integrity

15. The QC and LAQC rules were implemented when the company rate and top individual tax rate were aligned at 33 percent. Since their introduction, a gap has opened up between the top individual tax rate (38 percent) and the company rate (30 percent). Income is initially assessed at the entity level, so profits are taxed at the company rate. In contrast, any losses can be allowed as a deduction from a shareholder's annual gross income, which is taxed at up to 38 percent. This disparity creates arbitrage opportunities and raises a number of issues around tax base integrity. However, the importance of this issue diminishes if the top individual tax rate is reduced to (more closely) align with the company rate, for example, through other proposals being considered as part of Budget 2010.

16. In addition, the amount of losses that can be deducted may not be commensurate with the level of financial risk that the LAQC shareholder faces. That is, there is no loss limitation rule equivalent to that for limited partnerships, despite the similarity in economic terms between the LAQC shareholder and the limited partner. An LAQC shareholder can deduct losses in excess of their equity in the LAQC. The absence of a loss limitation rule is likely to distort efficient decision-making and resource allocation as a result of allowing investors to claim larger tax losses than their true economic losses.

Remission income loophole

17. Generally, a taxpayer is able to claim a deduction for an expenditure or loss for income tax purposes when it is incurred, even if payment has not taken place. The Income Tax Act 2007 claws back the unpaid portion of expenditure or losses through the remitted income rules. This does not occur in the case of LAQCs, as the benefit of the loss is enjoyed by the shareholders but the remitted income is derived by the LAQC.

18. Remission income arises in the year of remission, rather than in the year in which the deduction was originally claimed.[2] If remission income arises in an income year after the company has revoked its LAQC status, the directors and shareholders are not personally liable for the tax liability of the company, as that only applies in respect of an income year during which the company is an LAQC. As a result, shareholders can claim LAQC losses and then eliminate personal liability for the tax on the remitted income simply by revoking LAQC status before remission income is derived by the LAQC.

19. From September 2007 to September 2009, this loophole cost approximately $15.6 million. An increasing awareness of this loophole by tax practitioners, as displayed in recent cases, means there is a risk of the tax lost being much higher in future years. The total potential tax from current open cases is approximately $4.9 million.

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[2] Remission income includes an amount of debt that has been forgiven to a debtor.

Proposals for reform

20. Officials consider that the present LAQC rules are no longer appropriate. In order to address the issues described above, this report presents two options for your consideration.

21. The following proposals would improve the integrity and coherence of the tax system, and so are consistent with one of the objectives of major tax reform.

Option 1: Full flow-through for income tax purposes (officials' preference)

22. Currently, LAQC income is initially assessed at the company level (taxable at 30 percent), while losses are flowed through to shareholders (deductible from gross annual income at up to 38 percent).

23. Under this proposal, the current QC and LAQC rules will be replaced with a new set of rules to make QCs and LAQCs full flow-through for income tax purposes, similar to the treatment of limited partnerships. Both the LAQC's income and losses will be passed on to shareholders, so income will be taxed and losses deducted at the shareholder's marginal tax rate. As a result, there will be no arbitrage opportunities due to differences between company tax and higher personal tax rates.

24. A loss limitation rule for LAQCs, similar to that for limited partnerships, would need to be implemented if this proposal is preferred. Loss limitation rules prevent the flow-through of losses in excess of a shareholder's actual investment in any income year. A loss limitation rule would ensure that the net loss claimed by an individual reflects the actual level of that shareholder's economic loss. It is an appropriate policy treatment to allow taxpayers to offset, for tax purposes, only those net tax losses they have actually borne.

25. This approach is more consistent with the original intention of LAQCs to approximate partnership treatment for income tax purposes. It will also address the concerns about integrity and the use of LAQCs as vehicles for tax avoidance, as well as fixing the remission income loophole.

Implementation

26. If you agree to this proposal, an announcement on the proposed changes could be made in Budget 2010. After Budget, officials could release an issues paper on the implementation of the changes. The issues paper could consult on, for example, the most appropriate method for implementing full flow-through for LAQCs. The changes could be included in a bill introduced later this year, which allows for further consultation at the select committee stage. Officials consider that the changes to the LAQC rules could apply for income years commencing on or after 1 April 2011.

Option 2: Removal of QC and LAQC rules, company tax treatment

27. If the QC and LAQC rules were to be removed, standard company treatment would apply in the absence of any other changes. This would mean income and losses would be quarantined at the company level (subject to the standard grouping rules).

28. However, this approach would not be consistent with the original policy intent of approximating a partnership treatment. Furthermore, it would mean a flow-through income tax treatment would no longer be available for closely-held companies.

29. Given the equivalence of economic circumstances of LAQC shareholders and limited partners as discussed above, officials do not recommend company tax treatment. Instead, officials consider that the tax rules applying to limited partners are more appropriate.

30. It may be possible to allow a tax-free transition of LAQCs into the limited partnership rules. However, there would still be significant compliance costs from having to dissolve one entity (the LAQC incorporated under the Companies Act 1993) and form another entity under the Limited Partnership Act 2008.

Revenue implications

31. For the 2008 income year, loss-making LAQCs passed on tax losses of $2.294 billion to shareholders. More than $2.1 billion of these tax losses flowed through to individuals, and approximately $116 million flowed through to trusts. However, this does not provide indicative information on the revenue implications of reforming the QC and LAQC rules.

32. For example, removing LAQCs and defaulting to a standard company tax treatment would not automatically increase revenue by the tax effect of the above-mentioned LAQC losses, for the following reasons.

- Company losses may be able to be carried forward and offset against any income earned by the company in future years. However, company losses would be deductible at a lower rate than deductions from a shareholder's personal income (30 percent rather than up to 38 percent, assuming the existing company tax rate).
- The LAQC could be replaced by a partnership with full flow-through of losses or the assets generating losses could be transferred to an individual shareholder.

33. The revenue implications of the flow-through proposal would depend on what tax rules replaced them, the transitional relief provided (if any), and the reforms adopted in the Budget 2010 tax reform package. For example, whether depreciation on buildings is no longer allowed or if the company and individual tax rates are more closely aligned. Taking into account the likely Budget changes, any revenue gain is likely be small relative to the tax reform package as a whole.

Full flow-through

34. A full flow-through treatment will mean both profits and losses will be passed through to the LAQC's shareholders. This flow-through proposal is expected to increase revenue by up to $55 million per annum. The estimate results from the difference between the company and individual tax rates, and from the proposed loss limitation rule. The estimate assumes no change to the current company tax rate but a new personal tax rate structure.

Remission income

35. Implementing the proposals for either full flow-through income tax treatment for LAQCs or repealing the QC and LAQC regimes will address the remission income loophole (as described above). Inland Revenue audit has estimated the amount of tax lost from this tax

avoidance scheme at upwards of $7.8 million per year, with the potential for this to increase over time if awareness of the scheme increases. The total potential tax from current open cases is $4.9 million.

36. Correspondingly, it has been conservatively estimated that fixing this loophole will increase revenue by upwards of $7.8 million per year.

Ring-fencing of rental property losses

37. This section of the report looks at whether tax losses from rental properties should be ring-fenced, which would mean that losses could only be offset against net income from rental property investments and not offset against other income.

Background

38. New Zealand generally aggregates all the income and deductions of a taxpayer and applies tax on the net amount. It generally does not ring-fence income and losses from particular activities or investments and, therefore, does not restrict net losses from one source from reducing income from other sources.

39. You have asked officials to provide comment and information on the option of restricting investment housing tax deductions to the amount of rental income earned in any given year. This would mean that if the deductions exceeded the rental income for that year, the resulting net loss could not be offset against other income.

40. There are various options around how the excess deductions could be treated. They could be forfeited. Alternatively, they could be carried forward to future years and offset when there was sufficient rental income.

41. Since restricting housing losses would be an exception from the general treatment of losses, it would require amending tax legislation.

Objective of any reform

42. A key objective of ring-fencing would be tax base maintenance. The rental housing stock is estimated to be around $200 billion but currently generates an overall loss for tax purposes. The proportion of rental housing owners reporting losses on their properties has increased substantially over the past decade. The main expenses giving rise to tax losses are interest and depreciation deductions.

43. In theory, limiting the ability to offset these losses against other income would be clearly fiscally positive. It would result in the rental housing sector returning more taxable income, given that investors would no longer be able to immediately use the losses from investing in rental housing to reduce their tax liabilities. A number of major OECD countries have adopted some degree of ring-fencing to protect their tax bases.

44. Another objective would be to alter the long-term allocation of savings and investment. By reducing the after-tax return from investing in rental housing, there may be a marginal

shift of investment into other investment assets. To the extent that there is, in aggregate, over-investment in housing, this would potentially provide growth benefits.

45. A third objective might be to assist in dampening house price cycles. It has been argued that the ability to deduct tax losses against other income can make investment housing relatively attractive to investors at times of rapid house price appreciation and that ring-fencing could, therefore, have some suppressing impact on the cyclical movement in house prices by reducing demand from investors with low levels of equity.

Efficiency issues

46. Prima facie, applying loss ring-fencing only to investments in residential rental housing and not to other investments would distort investment behaviour, given that losses in other situations are generally not ring-fenced. Distortions could occur between rental property and other forms of investment, and between investing through debt and investing through equity. This could lead to under-investment in housing compared to other assets, including real property assets.

47. Ring-fencing may improve efficiency if it offsets another distortion in favour of housing, such as the non-taxation of capital gains. There is debate, however, as to whether this would be an effective means of countering any such bias. This is because the biases would arise irrespective of whether or not investment in these assets was highly leveraged. Also, borrowing to finance other investments (such as shares) which are also capable of making capital gains would not be ring-fenced. Thus, focussing on rental housing and on debt funding in particular may not appropriately target the problem.

48. Gearing is not the underlying problem from a tax perspective. The current tax treatment is relatively neutral between debt-financed investment and equity-financed investment. Rather the problem is that the investor is only being taxed on part of the economic return they are getting from the property. More specifically, the taxpayer is able to claim full deductions for expenditures incurred in respect of the rental property investment, while only being taxed on the rental income and not the capital gain. Quarantining losses does not counter this problem effectively. Instead, it is likely to result merely in a switch in the composition of investors, with high tax rate investors with adequate equity likely to replace those low equity investors driven out of the market by the loss quarantining.

49. If the outcome is that more high-equity investors would own rental housing, it would mean that they are investing less in other assets. Therefore, restricting losses may lead to not only a reduction in national borrowing but also a reduction in both housing and non-housing assets.[3]

Equity issues

50. Survey of Family Income and Expenditure data indicates that rental properties are largely held by those in the middle to higher income brackets. Increasing the effective tax

[3] If, say, a highly-leveraged investor sells a $400,000 rental property that was 90 percent geared, this will clearly free up $40,000 of that investor's funds which could be used to acquire financial assets. If, however, the property is acquired by a less leveraged investor, this will absorb more than $40,000 of that investor's funds which may reduce that investor's holdings of financial assets by more than $40,000. In aggregate, this is likely to put downward pressure on the level of non-housing assets New Zealanders own. Thus, restricting losses may lead to a reduction in national borrowing and a reduction in both housing and non-housing assets.

rate on these assets through loss ring-fencing rules is, therefore, likely to be progressive assuming that the rules can be made sufficiently robust to ensure that all housing rental property investors are subject to ring-fencing. In reality this may be hard to achieve as complicated avoidance structures are likely to be more affordable for higher income investors, which could mean that the impact of ring-fencing could then be substantially less progressive.

51. There is expected to be some impact on rents as a result of reduced tax benefits. This was the Australian experience when they introduced ring-fencing in the 1980s, with a spike in rents shortly after ring-fencing was introduced, and was a major source of pressure behind repeal of ring-fencing after two years. Treasury modelling suggests, however, that rent increases are likely to be modest. While there may be some regressivity involved in any resulting higher rents, some of this could be compensated for at low income levels through flow-on impacts to social assistance measures (such as the accommodation supplement). This point will be discussed more fully in the report on possible additional support for certain groups.

Integrity issues

52. There are a number of issues around the practicality of loss ring-fencing. It may be difficult, practically, to prevent taxpayers structuring around ring-fencing rules due to the fungibility of money and the difficulty in tracing and matching borrowings to particular investments.

53. If loss ring-fencing provisions are introduced, it is possible that more sophisticated taxpayers (especially those with other forms of business income) would be able to structure around the rules. This could be achieved by making it appear that borrowing was to finance business rather than rental investments. For example, suppose that a businessman had $1 million invested in a business which was financed with his own capital, and $1 million invested in rental property which was completely debt financed. With loss-limitation provisions, it would be much more attractive for this to be repackaged so that the $1 million of borrowing was being used to acquire business assets rather than the rental property.

54. Loss ring-fencing would also encourage holding property in a company and incurring interest on funds borrowed to buy shares in that company. In that way, no interest (and consequently no loss) is incurred with respect to the property itself. Feasibly, such drafting issues could be addressed for companies holding just rental properties but would be far more complex to resolve for companies with a mix of investments and purposes.

55. Consideration would also need to be given to the feasibility of including the significant amount of rental property held in trusts, LAQCs and partnerships.

56. Rules restricting loss offsets and interest deductions from rental property were introduced in 1982 but proved difficult to enforce and were repealed in 1990. Officials' concern at the time was that these provisions constituted an arbitrary and incomplete way of taxing capital gains or prospective capital gains, and that they could be easily circumvented by larger and more sophisticated taxpayers. The 1989 *Consultative Document on the Taxation of Income from Capital* noted that the provisions were widely considered to be unfair and that the narrow and selective nature of the measures made it possible to frequently escape their operation.

57. This experience suggests that, at a minimum, strong anti-avoidance rules would be required to implement ring-fencing and that the rules would likely be complex. It may be difficult to make them entirely robust.

Macroeconomic issues

58. There was some debate in 2005-06 about the merits of using loss ring-fencing to reduce property cycles. In a situation where asset values rise quickly, and the asset provides good security, the ability to deduct interest against other income increases the entry of people to the market with little initial capital or prospect of rental returns. At the time it was suggested that strong domestic demand, fuelled in part by the continuing buoyancy of the housing market, helped to fuel imbalances in the economy and placed increasing pressures on the competitiveness of the tradables sector of the economy.

59. Accordingly, some suggested that reducing the actual and perceived attractiveness of residential property investment, particularly highly leveraged investment in pursuit of capital gains, might have an overall small but desirable macroeconomic effect, even though it may lead to some inefficient outcomes due to the movement away from tax neutrality.

60. The desirability of using long-term tax policy changes to reduce current upward pressure on property prices is highly doubtful. To the extent that loss ring-fencing is prompted by concerns that property prices are too high, the policy may be less effective than it might first appear. It is targeted at rental housing only (although roughly two-thirds of housing is owner-occupied) and only at highly-geared rental housing. Moreover, ring-fencing is likely to lead to market adjustments which may limit its effectiveness.

61. Treasury modelling suggests that reduced cash flows from geared rental housing investment may result in a downwards pressure on property prices in the short run. In the long run, however, to the extent that housing supply is elastic, the modelling suggests that there would be little change to house prices. Consequently, the impact on prices should not be overstated.

62. Finally, it is worth noting that countries which have quarantined losses have still experienced large property cycles.

Design issues

63. Certain key design issues that would need to be considered include whether to restrict only the losses of residential investment housing, or to extend the limitation to other types of rental investments (such as commercial property), and what to do with mixed-use properties.

Restrict rental housing losses only?

64. An issue is whether any loss ring-fencing provisions should be limited to just rental housing or extended to commercial or industrial property, or even more broadly. Restricting loss ring-fencing to rental housing will provide incentives at the margin for those who are currently investing in loss-making rental housing to invest in other forms of rental property instead. This would require drawing boundaries between housing and other forms of rental property, which can be complex when property has more than a single use. Problems created with such boundaries may make it preferable to extend the restrictions to all rental property.

65. If the loss ring-fencing were to apply only to rental housing, the question arises as to how rental housing should be defined. The GST commercial dwelling definition may be helpful in this regard on the basis that losses from commercial investments are more akin to business losses. Under this definition, hotels or nursing homes, for example, would be commercial dwellings and, therefore, would not be subject to ring-fencing whereas the typical rental flat or apartment would be covered.

Existing investments

66. The tax treatment of pre-existing investments would also need to be considered. Approaches include: applying the new rules to all housing investments immediately; phasing in the new rules; or grand-parenting investments existing at the time of enactment or announcement (meaning the restrictions would not apply to existing target rental property - but they would apply to the next buyer of that property if sold). Given that buyers would have made purchase decisions under the law existing at that time, it may be considered unfair and cause some hardship for these investors to be subject to loss restrictions. Grand-parenting is typically used to provide relief where rules may cause such hardship. However, there are some unattractive features to grand-parenting rules. In particular, they would provide a strong incentive for individuals to be locked into their existing loss-making properties.

Revenue implications

67. Although limiting the ability to offset rental losses against other income will be clearly fiscally positive, the actual revenue gain will depend on other Budget initiatives (for example, denial of building depreciation – this may eliminate some losses – and new tax rates); any transitional rules regarding existing properties (for example, grand-parenting); and the "water-tightness" of the rules.

68. The static revenue estimate from an immediate and full implementation of loss ring-fencing rules is up to approximately $300 million per annum. The amount of revenue in the initial years would be much less if the measures are phased-in over five years. The estimates are after taking possible Budget 2010 depreciation and tax rate (except for the company tax rate) changes, and the LAQC changes proposed in this paper, into account. A reduction in the company tax rate would further reduce the estimates. However, the static revenue estimate could be understated because it is based on a conservative estimate of the impact of the depreciation denial proposal (to be discussed in a later paper).

69. This static estimate will overstate the true fiscal gains by not taking account of behavioural responses. Behavioural responses may be significant over time through investors finding ways around the restrictions, and through the composition of investors changing with fewer highly-geared investors and more higher-equity investors in rental housing.

Administrative implications

70. Any loss ring-fencing rules would, amongst other things, result in an increase in customer contacts for Inland Revenue and would need to be accompanied by an active education/information campaign. There may also be flow-on effects through reduced Working For Families tax credits and higher child support payments.

Conclusion

71. On balance, Inland Revenue does not favour the introduction of loss ring-fencing provisions on the basis that the economic case for ring-fencing is not convincing and the practical difficulties are likely to create greater distortions than the status quo; in other words, the disadvantages outweigh the advantages.

72. Treasury considers that loss ring-fencing may be worthy of further consideration post-Budget on the basis that these rules could help offset the existing bias created by the non-taxation of capital gains, and that there are potential growth gains from considering these matters further.

Capital/revenue boundary

73. This section of the report looks at a possible "bright line" test to clarify the boundary between capital and revenue (or income) in the tax system. It focuses on sales and other disposals of property and whether these give rise to taxable income or non-taxable capital gains.

Background

74. While it may have little foundation in economic theory, the distinction between capital and revenue has considerable practical significance within the tax system. This is particularly so in New Zealand given the absence of a general capital gains tax here.

75. In very general terms, the distinction is between flows of income (revenue) and one-off payments (capital). Over the years, the courts have laid down various principles for identifying this boundary. The classic analogy has capital as the tree or the land, whereas income is the fruit or crop it produces. As another example, a taxi driver uses a capital asset (car) to earn revenue (fares); but if the car is sold, any profit would be a capital gain.

76. In New Zealand, these case law principles are supplemented by statutory provisions, expressly deeming certain amounts to be income. For most forms of personal property, including company shares, two statutory tests are relevant.[4] The purpose test deems an amount to be income if the property was acquired for the purpose of sale or disposal. The business test deems an amount to be income if a person is in the business of dealing in property of that kind.

77. For land, including buildings and other improvements, the statutory provisions are more complex. Amounts from disposals can be treated as income in a range of circumstances. These include when land is acquired for the purpose or with the intention of sale or disposal; and when the person making the disposal is a land dealer, developer, sub-divider or builder if the property is disposed of within 10 years, or longer if it was acquired for the purposes of the business.

4 Other tests may also apply, including whether amounts are derived from carrying on or carrying out an undertaking or scheme entered into or devised for the purpose of making a profit. But these tests are not directly concerned with disposals of property and are therefore not discussed here.

78. There is a general exemption for owner-occupied residential property, although this does not apply if a person has established a regular pattern of buying and selling the properties in which they reside. Profits on the sale of an investment property would be treated as income if the property had been purchased for the purpose or with the intention of resale.

Uncertainty

79. The subjective nature of these rules can lead to uncertainty about exactly where the boundary between capital and revenue falls in particular cases. An approach that is appropriate in one set of circumstances may lead to inconclusive or even incorrect results in others. Key areas of uncertainty can include whether or not an item of property is on capital account, whether or not an individual is in the business of dealing in property, and whether or not an individual intended to sell an item of property at the time they acquired it.

80. These boundary issues can cause problems for taxpayers and Inland Revenue. They mean complexity and compliance costs for taxpayers, with the risk of inadvertent non-compliance by those who fail to appreciate when a disposal gives rise to taxable income. The rules may also create opportunities for tax planning, with taxable income being re-characterised as non-taxable capital gains.

81. Inland Revenue has identified a variable level of compliance with existing law and this has been treated as a high-risk area for some time. But the subjective nature of the rules creates significant challenges for audit and enforcement work. In particular, it can be difficult to establish and prove that a taxpayer had an intention to dispose of an asset at the time of acquisition.

82. The rules can also create distortions and inefficiencies. The Capital Markets Development (CMD) Taskforce expressed concern about a possible bias against direct investment in Australasian shares due to uncertainty about whether gains on directly-held New Zealand and Australian shares are taxable. For most foreign shares, and for domestic shares held through portfolio investment entities (PIEs), gains will normally be non-taxable.

83. A 2004 Treasury working paper noted that the existing rules may discourage equity investment in smaller or riskier firms.[5] Larger and more established companies are more likely to make regular distributions, making it easier to demonstrate that shares were acquired with a view to earning dividends rather than for the purposes of resale. Holdings in established firms may also be easier to leave unchanged for a longer period and require less active management – further indications that the shares are on capital account.

84. Concerns have also been raised about share market liquidity. In principle, the absence of a capital gains tax in New Zealand should improve this as investors can sell shares and realise gains tax-free. But it is also possible that the existing rules discourage people from actively trading their shares because of the risk that this will put their gains on revenue account, making them taxable.

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[5] *Financial systems and economic growth: An evaluation framework for policy*, New Zealand Treasury Working Paper 04/17 (September 2004).

Bright-line test

85. There is a question as to whether a "bright line" test, making it easier to distinguish revenue account property from capital account property, would help to address some of these problems.

86. One option for a bright line test would be a time-based boundary. This would involve treating the profit from disposing of an item of property as taxable income if the property had been owned for less than a specified period – for example, two years. This would act as a rough proxy for determining whether an asset had been acquired for the purpose or with the intention of disposal. The rule could be applied generally or be limited to particular types of property, such as company shares and/or various categories of real property.

87. This would remove some ambiguity from the tax system for property held for a limited period of time. The rule should be readily understood by taxpayers and more easily enforced by the Inland Revenue. Note that such a change could be perceived as introducing a general realisation-based capital gains tax for all property sales made within the specified period.

88. In policy terms, there are a number of drawbacks. As well as being arbitrary, a time-based boundary would create strong lock-in effects, with investors holding onto property for the required period in order to escape taxation. This would inefficiently tie-up capital that could be more productively applied elsewhere. It would also lead to the tax falling mainly on individuals who had to sell within the time period. Exemptions for difficult cases – such as for financial hardship, medical expenses and relocation – would introduce complexity and narrow the base. If applied to owner-occupied housing, a time-based test could also reduce labour mobility.

89. At the same time, it is unclear whether the change would actually address many of the problems identified above. Where a sale could be deferred until after the end of the time period, uncertainty and enforcement difficulties would not be resolved, simply deferred. The fact that a tax liability would now be certain (not merely a possibility) on disposals within the time period may be more likely to increase, rather than reduce, the biases against direct ownership of Australasian shares and towards investment in larger, more established firms.

90. The fiscal impact of the change would be positive but, depending on the length of the time period, the revenue may be small. First, in the case of a two-year test, many of those disposals made within the period would already be within the tax base (for example, disposals by traders), although this is unlikely to be the case for casual sales. Second, and more importantly, a strong behavioural response to such a rule would be expected. As noted above, those in a position to do so will simply wait until the end of specified period before selling in order to avoid the tax. New Zealand had a property speculation tax in the 1970s which attempted to tax disposals of residential property made within a two-year period. However, there were many exemptions and it was easily avoided, and so it yielded little revenue.

91. A further consideration is the treatment of losses. Bringing disposals made within a specified period into the tax base would mean allowing relief for losses as well as taxing gains. This would provide an incentive for people to sell assets that had fallen in value within the period in order to benefit from the losses – although people may also choose to hold onto loss-making assets if they expect gains over the longer term. To the extent that disposals of

loss-making assets are brought forward, this would further reduce actual fiscal gains. Loss ring-fencing rules could be introduced to ensure that the change could not become revenue negative overall, but this would increase complexity.

92. If Ministers decide that further work should be done in this area, this would include a full costing of a time-based test. It is expected that the behavioural response to any bright-line test would be significant, which would reduce any expected revenue gain. Increasing the length of the specified period would clearly increase any estimated fiscal gain, since a larger number of currently non-taxable transactions would become subject to tax. Again, however, behavioural changes would reduce any expected additional revenue gain.

93. A longer time period would also reduce (although by no means eliminate) behavioural responses, since it would become harder for people to delay disposals to avoid the tax. However, if the period specified was considerably longer – say, ten years – it would be difficult to regard the change as merely clarifying the capital/revenue boundary. There is already a precedent for a ten-year rule applying to real property as there are a number of provisions in the land taxation rules that achieve this end. However, officials note that such a change would effectively place residential property investors on a similar footing with property dealers, developers, subdividers, and builders, which would be considered a significant extension to the land taxation rules. Such reform would require careful analysis of a number of issues before proceeding.

94. Treasury considers that a time-based boundary may warrant further consideration if the period were sufficiently long, as it may clarify an existing boundary which could reduce ambiguity, provide revenue, and help address a number of existing integrity concerns. It would likely improve efficiency overall, similar to a capital gains tax, although lock-in issues would arise when disposals were made near the boundary.

95. Inland Revenue considers that a lengthy time-based test would raise much the same issues as would the imposition of a general capital gains tax.

96. If you wish to pursue this idea further, officials suggest making an announcement as part of Budget 2010 that further work will be undertaken in consultation with stakeholders.