The Treasury

Budget 2015 Information Release

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Housing Options

Date:	24 April 2015	Report No:	T2015/844
		File Number:	SH-3-2-18-16

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Discuss** with officials on 28 April 2015 at 4:15pm	28 April 2015

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Tom Hall	Manager - Housing	04 917 6150 (wk)		✓
Phil Whittington	Senior Analyst - Housing	04 917 6187	[4]	

Actions for the Minister's Office Staff

Refer to the Minister of Revenue and **return** the signed report to Treasury.

Enclosure: Yes. Housing Options Report - Table (Treasury:3169732)

Treasury Report: Housing Options

Executive Summary

This report responds to your request that officials quickly report back on three tax options and investigates the feasibility and advisability of announcing any tax changes to Auckland property in the very near future. Because of the very short timeframe, this is a longer and less considered report than we would normally provide.

The appendix to this report provides a summary table of all the options we have considered. The body of the report provides much more detailed analysis of various aspects of each option. Our conclusion on each option is:

Policy	**Conclusion**
Enforcement/clarification of current regime	
Greater funding for enforcement. (Temporary or permanent)	**Progress and announce.**
Greater information on existing transactions, including requiring IRD numbers for property. (Permanent)	**Progress and announce**. Will require extra funding for LINZ, which is not in current Budget. Will have to be managed through the between-Budget contingency or through some other mechanism.
Bright-line test requiring income tax to be paid if property bought and sold within two years. (Permanent).	**Progress and potentially announce** after consideration of retrospective elements (i.e applying to sales from date of announcement, etc).
Reduce demand from investors by reducing net returns	
Interest Levy / Partial Deduction Disallowance (scaleable). (Temporary)	**Do not progress** as "Auckland investment levy" is a better but similar option, and long-run efficiency costs of Interest Levy likely to be higher.
Auckland investment levy (perhaps 1%). This would be an alternative to the mortgage interest levy/partial deduction disallowance, but applies regardless of financing. (Temporary).	Would **need to consult with Auckland Council** before deciding feasibility. **Consider progressing.**
[8]	

Recommended Action

We recommend that you

a **discuss** this report and the summary table with officials in our 4:15pm meeting of 28 April.

b **refer** this report to the Minister of Revenue.

Refer/not referred.

Tom Hall

Tom Hall
Manager - Housing

Hon Bill English
Minister of Finance

Purpose of Report

1. The purpose of this report is to explore the feasibility of demand-side options to help contain house price growth in Auckland. We have been asked to consider three main options:

   - Strengthening the existing property income tax rules
   - An investor borrower levy

   [8]

2. In providing an overall conclusion on each policy, we have considered a variety of factors, including:

   - The signalling effect of the policy and its ability to stop or slow house price growth in Auckland. This in turn depends on whether fundamentals are driving the market, or whether there are bubble elements
   - Long-term impact on the housing market
   - Evaluation of tax policy measures under standard tax policy objectives such as economic efficiency, fairness and administration and compliance costs
   - Whether a policy can or should be restricted to applying in Auckland only
   - Any timing issues, including whether the policy can be announced before being implemented, or must/should be operative from announcement.

3. This report makes general points on the signalling effect power of any announcement as compared with longer-term objectives of the policies, the likely effects on various parties in the market, and some discussion of the timing issues, before finer points are discussed under headings related to each option. The appendix to this report provides a summary table.

General issues applying to all options

Interaction with Reserve Bank actions

4. Decisions to implement any demand-side options will need to take account of likely macro prudential intervention by the RBNZ. We understand the RBNZ will commence consultation with you next week about its intention to introduce new macro prudential policies. The RBNZ's macro prudential policies could have an effect on many of the same investors affected by the options in this paper. The cumulative effect of RBNZ and Government policies may be undesirable if it results in "overkill" – we do not know at this point. Assessment of the relative merits of the RBNZ and Government policies would need to be carried out over the early part of next week, as any Government demand side policies would need to be agreed by Cabinet on 4 May to be incorporated in the Budget documentation and be ready for a whole-of-Government position by 13 May, the date of the RBNZ's Financial Stability Report, where any further macro prudential policies would be announced.

Budget timeframes

5. Implementing the demand side options will have funding implications for IRD and in some instances LINZ. If these decisions are made on or after May 4 they will not be included in the estimates documents. Decisions with funding implications would need to be made early in the week beginning 27 April to be included in the estimates documents. In most cases we do not have estimates of costs. We cannot estimate whether costs could be absorbed within baselines at this stage.

6. Decisions that do not require new funding or could be managed within existing appropriations could be agreed on 4 May. Beyond this, it would also be difficult to reflect any tax revenue in forecasts. This means a Cabinet paper would need to be drafted over the course of next week. As noted above, a key complication will be assessment of the relative merits and co-ordination of government and RBNZ policies. We are meeting with you on 28 April to discuss this report and we are looking to set up a meeting between you and the RBNZ Governor and Secretary to the Treasury towards the end of next week.

The signalling effect

7. It is typical of financial cycles for fundamental drivers to cause asset (e.g. Auckland house) prices to rise for rational reasons before the possibility that momentum traders and 'euphoria' cause prices to overshoot rational levels. Prices eventually fall in response to some sort of shock that alters the expectations of sufficient market participants. In the context of Auckland, this could be a tax policy change or a policy that makes it clear that the supply problem will eventually be resolved.

8. "News events" can have a disproportionate effect relative to the information content, because they focus investors on a particular date or event. By focussing attention on this date or event, the investors synchronise their exit strategies, which leads to the market correction. Officials do not want to overstate how easily this can be accomplished, and such an intervention has risks of achieving nothing, or "overshooting" and creating a problem on the downside.

Are expectations unrealistic in Auckland?

9. In general, models of 'fair value' for housing can be constructed that suggest current house prices in Auckland are reasonable, if interest rates remain near current low levels and the supply issues in Auckland are not resolved. If we assume that migration trends reverse or cheaper supply is gradually brought on stream or interest rates rise significantly, current prices look less reasonable. Other indicators that the Auckland property market exhibits some features of unrealistic expectations are:

   - The highest ever price/rent ratio in history in New Zealand
   - The highest ever price/income ratio in history in New Zealand
   - Media stories of investors making very large returns from holding property
   - Media stories of first-home buyers "desperate" not to miss out at an auction and see prices move higher, and therefore bidding "whatever it takes"
   - Anecdotal stories of foreign buyers buying multiple properties in short time frames with very little due diligence
   - International and domestic evidence that most housing investors simply extrapolate recent returns in the expectations of future returns, and very high recent returns in Auckland.

- The high rate of change, in an environment where it is hard to pinpoint new fundamental information justifying large price changes.

10. On balance, it seems to us that a significant number of market participants are underestimating the likelihood of fundamentals changing, or overestimating returns going forward due to adaptive expectations in an environment that has experienced consistently rising prices. There are anecdotal aspects of "bubble-like" behaviour described above, although not every typical "bubble-like" behaviour appears to be present.

Why it matters

11. If there is no bubble, the tax changes suggested have relatively small effects on market prices and are unlikely to be effective in stopping growth in prices. However, because we think that unrealistic expectations are driving prices in Auckland (i.e there are "bubble" elements), our overall conclusion is that there could be a material impact from the announcements to the extent that unreasonable expectations are reset.

Trade-offs, general considerations, and tax policy

12. To the extent that concerns about property prices are regional, the most effective policy changes are likely to be regional. If the general tax system is used to achieve this, there are some trade-offs to consider. The more the tax system is used for short-term macro policies or regional policies, the less clear and coherent its broad-based, low-rate structure is likely to become. Part of the reason that the tax system works well in New Zealand is because of neutrality and the fact that it is not used for objectives other than raising revenue as fairly and efficiently as possible to finance Government spending. This helps in making the tax system as coherent and comprehensible as possible. This needs to be weighed up against effectiveness in meeting the Government's Auckland housing concerns.

13. At the same time, some sensible tax policy changes that could be justified purely on standard tax-policy grounds may also be helpful in meeting the Government's wider housing objectives. The justifications for a temporary, Auckland specific change are that:

    - There is only a desire for a signalling effect to impact on investors in the Auckland market, rather than the national market. As we expect policies with the greatest signalling effect to diminish in their effect over the long term, and some of the policies have undesirable long-term efficiency costs, limiting their application for the period Auckland is experiencing very high house price growth is justified.

    - The current tax system does not adequately tax house-price appreciation. A policy change that increases the tax impost on housing should be limited to the region experiencing rapid house price appreciation. That is Auckland.

14. If policies are considered on a regional basis, there is an important fairness consideration. If a levy is imposed on Aucklanders, it may be appropriate for the revenue to be available to the Auckland Council. We have not addressed this issue in the report, but note that if it was hypothecated for Auckland Council, it could be further specified that it must be spent on growth infrastructure for housing. We recommend that if you are considering an Auckland specific levy and are interested in the revenue being hypothecated to Auckland Council, that you ask officials to raise this with Auckland Council, or your office to raise it directly with the Mayor's office.

15. Many of the goals for any announced policies are in contrast with our standard tax policy goals. Standard income tax policy goals include generally minimising inefficiencies and distortions. But for current purposes, these goals are reversed to the

extent that the Government would be sending a dramatic signal to the market about investment in Auckland property. Nevertheless, in the longer term, in the case of some of the policies, the economic costs of distortions and inefficiencies introduced would be material, and these should be considered.

Long-term economic efficiency of each policy

16. Policies introduced as a way of trying to address any speculative activity will also affect the fundamental incentives faced by people in the market. These changes can distort investment choices and have broader-reaching impact, particularly if those policy changes are permanent.

17. [8]
Policies more in line with New Zealand's broad-based, low-rate tax system, and that are more of a progression from the existing rules, rather than a relatively radical departure from the current tax policy approach, are preferred on this basis. These options are:

- Greater funding for enforcement of the existing rules
- Greater information on existing transactions, including requiring IRD numbers for property purchases
- A bright-line test

18. Further, a withholding tax system for gains on short term property purchases and sales is likely to have some of the biggest benefits, and if not for concerns about an overheated property market, there would be a strong advantage in considering this less urgently and in a way which allows fuller consultation.

19. [8]

Effect on supply

20. There may also be effects on the market for new housing supply. While high house price growth is a prima facie incentive to developers to bring forward housing supply, it also raises the option value of delaying development. It is not clear which of those effects dominates. It is possible that reducing the expectation of future capital gains would encourage landowners to bring forward housing supply.

21. In general, options which discourage investor activity have the potential to impact on the demand for new housing development, particularly apartments. For multi-unit dwellings a high level of pre-sales is generally required (often 80%). If demand from investors is reduced, developers may have to wait longer to achieve their required pre-sales or make the development not viable with a consequent impact on new supply.

22. Overall, our view is that any impact on supply is likely to be minor, as prices are likely to remain sufficiently high that there will still be a strong incentive to build houses. Despite this, because of the risk of a counter-productive reduction in supply, we suggest that development market sentiment will need to be closely monitored and taken into account as any policies are rolled out.

Effects on various parties in the market

23. All of the tax policies are targeted at investors. The result of this is likely to be a contraction in the price/rent ratio and an increase in owner-occupiers and decrease in renters. The size of this effect will vary by each policy. If a particular policy is effective in addressing unrealistic expectations, we would expect a proportionately much larger effect on the price as compared with the rent, because rents are far less likely to be affected by unrealistic expectations than prices. If the policy changes the fundamental incentives to invest in residential rental property, the implications for the rental market may be larger if the result is a significant withdrawal of supply.

24. Because the goal is to reduce current prices, prospective homeowners will gain, while existing homeowners will lose, relative to the status quo.

Timing

25. There are trade-offs in the timing of possible changes. One question is whether tax changes should apply purely prospectively. It is attractive in terms of creating certainty to make tax changes purely prospective. But this may reduce their impact on the housing market. There is a trade-off between the power of the announcement on the market, and the traditional policy approach of more prospectivity. Inland Revenue considers that tax is a poor and inflexible macroeconomic timing tool, and notes that stakeholders expect reasonable periods of consultation.

26. The other timing issue is whether any policy change should be temporary or permanent. In general it is better to use the general tax system for measures that are considered to be good long-term tax policy. Temporary and regional problems are best addressed through temporary and regional solutions. Such measures could be tied to either falling or stable prices in Auckland, or significant increases in supply. Putting a distinct time-frame on these policies unrelated to broader market movements could be counterproductive, in the sense that investors may be willing to delay their purchases, rather than revisit their expectations for the market.

Option 1: Enforcement and Strengthening of Existing Rules

27. There are three aspects to this section:

- Enforcement of existing rules through additional Inland Revenue compliance actions
- Improving tax compliance on existing property transactions through provision of greater information from Land Information New Zealand (LINZ) to IR
- Strengthening the existing land rules to ensure that short term buying and selling is subject to tax.

Enforcement of existing rules

28. On 20 April 2015 the Minister of Revenue took a paper to Cabinet seeking to extend investment in IR's investigations and collections activities by $74 million over five years. Through scaling up activities in property compliance, hidden economy and aggressive tax planning this was to generate additional revenue of $642.388 million over the five years.

29. The paper did not direct the level of split across these three areas although an earlier note to the Ministers of Finance and Revenue had indicated half the funding would be used to target the hidden economy and the remaining to be split evenly across aggressive tax planning and property compliance.

30. Our understanding is that while Cabinet has approved the funding sought in the paper, it did not direct how this funding was to be allocated within those three activities.

31. Inland Revenue has further indicated that the allocation of funding to property compliance could increase from the 25% suggested in the note to Ministers to 40%, with 35% to hidden economy with aggressive tax planning remaining at 25% of the funding. Such a change could occur with no reduction in revenue generated at $8 for every additional $1 spent as set out in the original Cabinet report.

Who is affected

32. Affected taxpayers will be those who have bought property with the intention of resale, sold but then not returned the gains to the extent that Inland Revenue is able to prove their intent at the time of purchase.

Feasibility and timeframes for implementation

33. The additional investigation compliance activity can start from the receipt of the additional funding. This can be announced at any stage.

Can this activity be restricted to Auckland?

34. While IR cannot be directed to target Auckland sales, the reality is that given the significant lack of compliance in this area it will be overrepresented in its efforts.

Risks

35. There is a risk that the increased focus on property compliance will come at the expense of other areas with greater compliance risk.

Improving tax compliance on property transactions

36. Under this option purchasers of property would be required to provide their IRD tax number/s along with the current identity information requirements as part of the conveyancing process. This would be required to be provided to LINZ to effect the transfer of the property.

37. Currently, solicitors undertaking conveyancing transactions are required by the Land Transfer Act 1952 to identify the parties to the transaction, generally by way of checking government issued photo identification (such as a passport or drivers licence). The solicitor is also required to keep a copy of the identification on file for 10 years. Inland Revenue currently obtains information regarding property transactions from LINZ via a commercial arrangement. This information comprises the name/s of the purchaser and the title details of the property.

38. We propose that in addition to checking and keeping the identification information, the solicitor would also be required to collect the purchaser's IRD number and, in the case of non-resident purchasers, their tax file number in their home jurisdiction. We also propose that the purchaser be required to state whether the property will be owner-occupied. This information would then be provided to LINZ as part of the property transfer process. Inland Revenue would then obtain this information from LINZ and it would be used to ensure compliance with the tax rules.

39. Consistent with our international obligations, information would be shared with other tax jurisdictions.

Who is affected

40. All purchasers of property will be required to provide additional information to their solicitor who will then pass it to LINZ via the property transfer process. The tax consequences will arise for property speculators through Inland Revenue being able to more easily track and identify property transactions where it is likely that property was purchased with the intention of re-sale and thus tax is owed on any gain.

41. Other people who are affected include:

- Owners of rental properties: Inland Revenue will be better able to identify properties where rental income should be expected to be returned

- Hidden economy: Inland Revenue will be better able to identify situations where the money used to purchase the property does not have clear provenance, for example where there is not sufficient declared income to support the purchase.

42. We cannot estimate the percentage of property transactions that may have tax implications. This proposal will impose information provision requirements, and therefore a compliance cost burden, on all property purchases, although many of these transactions may not have any tax implications.

Market impacts

43. This measure is likely to place downward pressure on property prices. [9] We expect that part of the impact will manifest through off-shore purchasers being concerned that their purchase will be reported to their domestic tax authority.

44. This measure would strongly support New Zealand's commitments to international transparency, FATF (Financial Action Task Force) and anti-money laundering initiatives. There is likely to be a significant increase in spontaneous information exchange with other countries.

Feasibility

45. A requirement for an IRD number will likely increase the number of IRD numbers Inland Revenue is required to issue, particularly in relation to non-residents. Inland Revenue would not require additional funding as issuing IRD numbers is part of its core functions.

Impact on LINZ

46. This will require extra funding for LINZ which is not in the current Budget [8] We would envisage that a proposal to investigate such an option could be announced on Budget Day with consultation to follow. Legislation could be introduced as part of the November 2015 tax bill [8] LINZ suggest the system could be up and running from mid 2016.

Can this be restricted to Auckland?

47. The policy could be restricted to Auckland. However, while non-compliance in relation to property transaction is a concern in relation to the Auckland market, the issue is not unique to Auckland.

Risks

48. There will be an impact on the conveyancing process. We have not had the opportunity to consult with the New Zealand Law Society regarding this impact.

49. This proposal will require further information provision by all purchasers of property, meaning it will impact a significant number of people for whom there is no taxable implication of their property purchase (i.e. owner-occupiers). This may also increase the cost of doing business in New Zealand slightly.

50. This proposal introduces a requirement to have an IRD number to purchase property. There is not currently a requirement to have an IRD number (with the exception of the requirement to obtain a GST registration once the taxable supplies threshold is reached).

Other benefits

51. Offshore purchasers of property in New Zealand will be more visible to both Inland Revenue and the person's home tax jurisdiction. It is proposed that the information received by Inland Revenue for compliance purposes would also be made available to Treasury and the Reserve Bank for statistical purposes (no taxpayer details would be provided).

Strengthening of existing rules

52. Currently the tax rules tax the gains from the sale of property where it was bought with an intention of resale. In practice, it is often difficult for Inland Revenue to apply and enforce these rules as it relies on proving a taxpayer's subjective "intention". This means that the scale of trading has to be close to that of a business before Inland Revenue can be certain that the land-sale rules apply.

Bright-line test

53. One option to counter this is to create a rule that residential property sold within 2 years of purchase is taxable. This would apply to all residential land sales unless the property

    - was the seller's principal place of residence; and
    - was not used as a rental property[1].

54. This option helps address the subjectivity of the intention test. It creates a clearer rule than the intention test that is easier to enforce and ensures that persons who turn properties over quickly are taxed on their gains. It would however have no effect on anyone who was land banking as by definition that involves long term holding.

55. Such a change to the rule would bring all residential, non-owner occupied land sales to tax if within the 2 year period. We note however that the issue of any losses on these land sales would need to be further considered.

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[1] New Zealand last had a bright-line test like this with the Property Speculation Tax Act 1973 (repealed in 1979).

56. There is evidence of very rapid churn in some new developments in Auckland. From 2009-2013, 59% of all new titles were disposed of within a year and 29% of new developments in North Auckland were traded within 3 months. We do not fully understand the reasons for this very rapid churn but some will reflect sales by non-residents. This can be contrasted with other data, like the number of sales in Auckland per year, suggesting that on average, properties do not churn at a very high rate at all. To the extent there is localised very short churn, the above bright line test would capture the very short term churn, including off-plan purchases and short-term purchases by foreigners who do not live in the properties.

57. The effects of such a bright line test would be any of the following:

- Additional tax is paid
- Churn is reduced to 2 years
- [9]
- Churn is unchanged but buyers and sellers evade collection putting pressure on Inland Revenue to enforce.

Withholding taxes

58. [9] consistent with Inland Revenue's business transformation timelines, we could look at the creation of a withholding tax obligation. This would require a withholding from the property settlement proceeds of an amount on account of the income tax on the gain. This withholding would be paid to Inland Revenue prior to the registration process with Land Information New Zealand.

59. There are a number of overseas examples of withholding taxes on property sales by non-residents. This includes USA, Canada, and some European countries.

60. The timelines would however need to be worked through with those of the Business Transformation project but could come after the initial implementation to buttress the collection of this change. [9]

Who is affected

61. The option for a bright-line test would impact on all persons who sell residential property within two years of purchase.

Economic impacts

62. At the margin, greater enforcement and strengthened land rules may put some downward pressure on prices. Reducing property speculation will mean that greater risks will tend to be covered by those who would prefer not to take on this risk. For example, it may become more common, at the margin, for individuals to enter into contracts to buy property that is not yet constructed.

63. The bright-line test would be a way of defining when people selling property within short time periods are taxed. A key problem at present is a lack of clarity. At the same time bright-line tests can be very inefficient as they can be circumvented by people holding property long enough to beat the bright-line test, biasing decisions on when property is sold while raising little revenue. It is hard to know how important this ability to delay sales will be. There is a considerable turnover of property with very short

durations (e.g. less than three months) in some localised areas, and it may not be viable to delay these sales beyond two years.

64. The intention of the bright-line test would be to make current rules work much more as intended. To this extent they are likely to promote fairness. At the same time, they will not apply to speculators who are able to delay sale beyond two years while they will apply in circumstances where people outside the principal residence exemption are forced to sell for unexpected reasons (e.g. an urgent expense). This may be criticised as unfair.

65. The aim is to have clearer rules which should tend to reduce administration and compliance costs and make the intention test more enforceable. [9]

Feasibility and timeframes for implementation

66. There are a number of implementation options for the bright line test. They could apply to:

- All property acquired after Budget announcement (i.e. full grand-parenting), or
- All property acquired after introduction of legislation (which would be several months after Budget announcement).

67. The option for a bright-line test is within the existing functionality of Inland Revenue's FIRST system and as a result can be implemented within a short timeframe (for example applying from Budget night). The option for withholding taxes would require substantial systems changes and therefore would take longer to implement.

68. Our expectation is that legislation could be introduced soon after announcement with the detail further refined at select committee.

Can this be restricted to Auckland?

69. Although it is possible to target these options to Auckland it is a more general change to the income tax rules (as opposed to a regional "levy") regarding property, and targeting this particular rule to a specific region of New Zealand and would not be a desirable precedent.

Risks

70. As we are not following the generic tax policy process, there will be increased pressure on the select committee process to ensure that the ultimate design and legislation is workable.

71. A bright-line test can be harsh for people on the margin of the test. It may be considered inequitable that a person who sells land 1 year and 364 days after acquiring it is fully taxed on the sale but a person who sells the land 2 years and 1 day after acquiring is not taxed.

72. [9]

Option 2a: Reducing net returns for leveraged investors

73. Because rental yields (taxable income) on property are often below interest rates, there is prima facie evidence of a tax preference for rental housing. Only part of the economic income is being taxed.

74. While the use of debt financing for residential rental property does not increase the tax preference (which is related to the partial untaxed return), it does increase the accessibility of that investment to a broader range of investors increasing demand for housing from that group. Demand for housing from leveraged investors could be reduced either by reducing access to credit or reducing the net return.

75. Policies that reduce access to credit such as a loan-to-value ratio limit are within the remit of the Reserve Bank.

76. The Government has levers which could lower the net return that leveraged investors receive from that investment. Two ways of doing so are discussed below:

    - A levy to be collected by the banks in a similar way to withholding tax
    - A complete or partial disallowance of interest expense deduction on either Auckland residential property investment or nationwide (e.g. 50% of the interest deduction is disallowed).

77. Conceptually the two options are very similar. Both options are discussed below.

78. The purpose of the change is to reduce the attractiveness of leveraged residential rental property investment in Auckland. The key design choices are:

    - New debt or all debt including existing debt - A change only for new mortgages obtained by debt-funded investors would have an impact on the purchasing intentions of those investors which should reduce overall demand for housing assets in Auckland. If the change also applies to existing borrowers, it would raise the on-going costs for those investors. This may encourage existing investors to sell their rental properties which would significantly add to the effect of the change.
    - Auckland or nationwide - It is likely to be technically possible to impose a policy change just on Auckland properties using both approaches. A regional approach would make it administratively more complex and raise questions of fairness at borders, but would increase the compliance cost only for Auckland investors.
    - Temporary or permanent - A temporary change is likely to have less of an impact than a permanent change as investors may feel they can absorb the additional cost for the period the change is in place. Modelling suggests a temporary change (e.g. 3 years) may only have about one-fifth the impact on house prices as a permanent change over the short-term. If the policy is temporary it is also necessary to determine what process is to be used for deciding whether to remove it.
    - Whether to exempt new builds - Investors are a significant contributor to demand for newly constructed apartments and to a lesser extent other dwelling types. Given the high proportion of pre-sales needed before such projects can proceed, reducing demand from investors may reduce the likelihood that such projects go ahead – with a negative impact on future supply. Exempting newly built dwellings for a period of time would minimise this effect and would create a regulatory bias

for leveraged investors to favour new dwellings over existing dwellings – all other things being equal.

- Size of the levy – some assumptions are made below.

Who is affected?

79. The group affected will primarily be investors in Auckland rental properties who finance their investment partially with debt from New Zealand sources. Investors who own or finance their rental property investment with 100% equity will remain unaffected, as will owner-occupiers. Investors who use foreign sources of debt will be not be affected if the levy is collected via New Zealand banks but will be affected if the tax deductibility method – presuming they deduct their interest costs from taxable rental income.

80. We do not have definitive data on the number of investors with mortgages in Auckland. The ANZ Residential Property Investment Survey 2014 suggests just over 90% of investors have some level of mortgage. This is likely to be an over-estimate. CoreLogic data from 2013, indicates that of the 3,153 sales of properties to Multiple Property Owners (MPOs), 2,395 (75%) were to MPOs with a mortgage on the title.

Economic impacts

81. In general, in the short term, reducing the net return from leveraged rental properties would **reduce demand** by leveraged investors. This is likely to both reduce competition for properties for sale and may increase the supply of housing assets for sale if existing investors decide to exit the market. Overall we would expect a reduction in house prices relative to the counterfactual. Over the longer term, the effect on house price growth would weaken as investors with higher levels of equity and owner-occupiers increase demand.

82. The size of the effect will depend on the exact design choices made and particularly the size of levy. Modelling has been done on two options:

    - 2% levy on all the principal borrowed, applied temporarily (say for 3 years) with exemption for borrowing against new builds

    - Permanently disallowing 50% of interest deductions with a temporary exemption for new builds.

83. Using a simple discounted rent model, a 70 percent geared investor facing the first option would face a 4 percent decline in the value of the rental investment. The second option for a 70 percent geared investor would result in a 19 per cent reduction in the expected value of the investment.

84. These are not estimates of the size of the impact on the market price given that there are other types of buyers in the market. If we pro rata the effect according to the proportion of sales to leveraged investors (around 28% of total buyers), the impact on the market price could be 1.1 percent for option 1 and 5.3 percent for option 2. Though the effects on house prices are very difficult to predict this could be an under-estimate of the shorter-term impacts, given that geared investors are often likely to be the marginal buyer in the market. At the same time, this also depends on how quickly portfolios are rebalanced to finance housing with equity rather than debt. We advise that these estimates should be read with caution given the simple nature of the model and the large number of uncertainties about the behaviour of investors and other market actors to any proposed change.

85. In terms of standard tax policy objectives, these measures would tend to bias ownership of rental property in favour of those who are able to do so with their own funds. This is likely to mean that rental property is not held by those who are necessarily the best landlords and that risk of house price changes is not borne by those most willing to bear it.

86. If there is a net reduction in the number of properties available to rent there is likely to be a commensurate increase in the ownership rate. When people are tipped into highly geared owner occupied housing this can reduce the incentive for overinvestment in housing. This would tend to decrease the bias between rental housing and debt-financed owner-occupied housing but increase the bias between rental housing and equity-financed owner-occupied housing.

87. On administration and compliance costs, partial deductibility would require changes which would be going in the opposite direction to normal tax rules where interest on money borrowed to invest in companies is generally deductible. Restrictions on deductibility have been imposed in the case of mixed-use assets. But these are generally seen as complex and very harsh. This has been seen as acceptable for mixed-use assets because it can be argued that there is no particularly good reason for holding these within companies. It may be less acceptable to stakeholders to have harsh rules on interest deductibility for rental properties held through companies.

88. The impact on the rental market will depend on the size of the reduction in rental supply and the fall in demand from households that can now move from the rental market to become owner-occupiers. The overall likely effect is to marginally increase rents and increase occupancy/over-crowding in rental properties. The degree to which this will occur depends on whether new owner-occupiers are creating new households (e.g. moving out of a flat or parents home) or just shifting the household from rental to ownership tenure.

89. There is a potentially **negative effect on new housing supply**. Given the role that we believe investors are playing in providing developer finance and therefore bringing forward new dwelling supply, we think an exemption for new builds is desirable. Given the distortion this would create between new and existing dwellings for leveraged investors, this should be limited to 3-5 years.

90. In terms of broader market impacts, it is worth considering the impact on the Social Housing Reform Programme. Details have not yet been finalised but if Community Housing Providers (CHPs) purchase freehold properties for the provision of social housing and finance those purchases through mortgages, an investor borrowing levy may also raise costs for them. The alternative mechanism of a change to tax deductibility would not affect the CHPs if they have charitable status.

91. A change to increase the costs to investors (or lower net returns) is likely to increase the number of investors declaring profits on rental properties and therefore reduce tax losses. Tax revenue should increase in the short term but the higher tax revenue may decrease in the longer term as new investors substitute equity from fully-taxed investments.

Feasibility and timeframes for implementation

92. A levy could be imposed directly via the banking sector through a withholding tax. A conceptually similar outcome could be achieved by reducing the amount of interest investors could deduct against their income by an amount equivalent to the preferred size of the levy.

Levy

93. Banks' systems tend not to classify investors in a way that would make them readily identifiable as a group or meet the definition of investors compatible with the objectives of the levy. The Reserve Bank is currently consulting on a requirement for the banks to classify investors into a separate asset class for assessing capital requirements. It is possible this could be used to identify investors but the definitions may not completely overlap. For example, if an investor is able to meet their mortgage requirements without recourse to the rental income from the property, they may be deemed not to be an investor for asset class purposes.

94. Banks would require significant systems changes to be able to start collecting such a levy. A lead time of at least 12 months would be needed to implement after policy decisions had been reached.

95. The levy option would require substantial systems changes for Inland Revenue and therefore would take longer to implement. With the current work underway to facilitate Business Transformation it is important that the current configuration of the FIRST system is not affected. Introducing a new levy would be regarded as changing the configuration of FIRST.

Lower tax deductibility

96. The alternative of implementing a change to the tax deductibility of interest, relies on taxpayer self assessment. We rely on investors to self-declare where their property(ies) is/are and to correctly declare net rents. The adjustment to declarations could be done within the existing fields on the tax returns. Additional enforcement activity may also be needed to ensure adherence to the rules.

97. Collecting additional information for interest deductibility, while not as complex, would also be considered configuration of FIRST. However, a partial disallowance of interest deductibility would be possible within the current IR3 and IR3R returns from after the 2015/16 tax year.

98. Using the existing tax system has the advantage that the systems are already in place, though would require tweaks. However, a disadvantage is the annual cycle. Implementation (and potentially removal if temporary) could only coincide with the tax year meaning long lead and lag times. Another disadvantage is that investors would only be assessed at the end of the year and may not know how big a levy they would face until the end of the year. Although the desired effect of reducing demand for rental properties may happen earlier when investors become aware of the new tax.

99. A change to the interest deductibility would involve significant complexity for companies that also include other types of investment. We do not have good data on how many companies this is likely to affect. Inland Revenue considers that this is an important concern.

100. It could be announced on Budget 2015 applying to new debt/or investment made from budget day but with effect from the 1 April 2016 income year. Other transitional options are possible or it could apply to existing investments, which would have a stronger short-term market impact but could be viewed as applying a new tax to existing investments.

Can policies be restricted to Auckland?

101. In principle, both implementation methods could be restricted to Auckland properties.

102. Banks will know the address on which the mortgage is attached. However, an investor may have properties in more than one region and could reallocate debt to properties outside Auckland to avoid the levy.

103. Similarly if the tax deduction method is used - there is a risk that taxpayers with a portfolio of properties could overallocate interest expense outside of Auckland and underallocate interest expense to inside Auckland. Anti-avoidance rules could be considered to address this.

Risks

104. The mechanism would be blunt and difficult to reverse if the situation changed making the additional tax undesirable (e.g. prices begin to fall rapidly in Auckland), although the reduction in leverage may help mitigate risks to the financial system. With all Auckland-targeted interventions, property speculation may shift to areas outside of the defined Auckland area.

105. There is a risk that investors switch debt for equity and don't alter overall demand behaviour. In this case, the housing market impact would largely be temporary and reduce over the longer term.

106. Overall officials recommend against this policy, and suggest a different option that taxes both equity and debt, and is likely to be administratively more simple. That option is the Auckland Investor Levy.

Option 2b: An Auckland Investor Levy

107. A policy change with a similar intent but broader impact could be a levy on the capital value of rental properties in Auckland. This would have the advantage of having a consistent impact irrespective of how rental properties were financed.

Who is affected?

108. Owners of residential rental properties in Auckland irrespective of how that investment is financed. Owner-occupiers would not be affected.

Economic impacts

109. Such a levy would reduce the overall return to residential rental property investment in Auckland and should therefore reduce demand for dwellings from investors. We would expect this to lead to lower house prices compared to the counterfactual and a higher home ownership rate as owner-occupiers replace investors as the marginal buyer.

110. The rental market will shrink both in terms of supply and demand. Some renters will become home owners but the supply of rental properties will also fall. The net effect is likely to lead to a rise in rents.

Feasibility and timeframes for implementation

111. Feasibility is uncertain at this stage. Implementation by IRD would face similar system constraints to other options. It may be possible to have the levy imposed/collected by Auckland Council but they do not have any information about whether a dwelling is owner-occupied or rented. There would need to be a combination of two or more systems to achieve the data-match necessary. One advantage is that because this is an annual tax, it could be announced (or at least the intention to progress work on it), and have an immediate market impact, with no bringing forward of transactions to avoid the tax. The tax itself would begin later.

Can this be restricted to Auckland?

112. This policy could be restricted to Auckland and perhaps could be justified on the basis of a large proportion of Auckland rental property gains being untaxed because those returns come through capital appreciation rather than rent. In this way the Auckland Investor Levy could be set to approximate a tax on future capital gains. A 1% levy, plus a rental yield of 4%, assumes that gains going forward are 7% and are fully taxed (under an assumed 33% marginal tax rate).

Risks

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114. There may be system issues which take longer than expected to sort through.

115. If Ministers were interested in a longer-term, nationwide variant of this policy, one option is applying the risk-free return method. This option has not been developed in this report, but we have previously advised on it, and it was proposed by the McLeod tax review and the Tax Working Group.

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Policy	Signalling / Short-Term Housing Impact	Long-Term Housing Impact	Long-run Economic Efficiency	Equity	Admin and compliance costs	Auckland Only	Timing	Recommendation
Enforcement/clarification of current regime								
Greater funding for enforcement. (Temporary or permanent).	Limited. At the margin may prevent some buying and reselling with consequent impact on prices	Reduced impact on house prices in long term as speculative demand works itself out.	Ensuring tax is paid on gains on some actively generated capital gains increases economic efficiency.	Improves equity with those who are already caught by existing rules.	By definition administration costs increased. Compliance costs increased to the extent taxpayers now have to interact with IRD investigators.	No but given the compliance risks in Auckland are significant, the additional activity will be predominately focussed there.	Could be announced at Budget	Progress and announce
Greater information on existing transactions, including requiring IRD numbers for property. (Permanent)	Moderate. May prevent some buying and reselling behaviour with consequent impact on prices. Could have outsized impact on foreign investors given compliance costs.	Reduced impact on house prices in long term as speculative demand works itself out.	Ensuring tax is paid on gains on some actively generated capital gains increases economic efficiency.	Improves equity with those who are already caught by existing rules.	Administration costs and compliance costs will increase, but compliance costs will largely be for non-residents who will have to register for an IRD number.	Yes but not recommended.	Could be announced with budget, with consultation and legislation in November 2015 tax bill.	Progress and announce. Will require extra funding for LINZ, which is not in current Budget. Will have to be managed through the between-Budget contingency or through some other mechanism.
Bright-Line test requiring income tax to be paid if property bought and sold within two years. (Permanent)	Moderate. May reduce prices in short term.	Reduced impact on house prices in long term as speculative demand works itself out.	Taxing gains on some actively generated capital gains increases economic efficiency. Taxing gains made by non-residents promotes efficiency [9] Bright –line tests can change behaviour while raising little revenue which can reduce economic efficiency.	Improves equity with those who are currently caught by existing rules.	Likely to reduce administration and compliance costs through greater certainty. A subsequent withholding tax (not expected for at least 18 months) could increase compliance costs while boosting effectiveness.	Yes but not recommended.	Could be announced with budget, detail design in time for legislation. Many options for application (property bought from start date, property sold from start date, etc.). A risk if introduced at the top of the market and investors claim losses.	Progress and potentially announce after consideration of retrospective elements (i.e applying to sales from date of announcement, etc).
Reduce demand from investors by reducing net returns								
Interest Levy / Partial Deduction Disallowance (perhaps 50bps) (scaleable). (Temporary)	Strong – reduce demand for investor housing, reduce prices overall. Lower prices for owner-occupiers, possible higher rents.	Reduced impact on house prices and rents in long-term, likely to affect how investor property is financed.	To the extent that the proposal reduces undertaxation of rental property, this will promote efficiency. But undertaxation arises for both debt and equity financed rental housing. This distorts investment in favour of equity financed rental housing.	Horizontal equity – rental property owners face higher effective tax rate (although effective tax rate is already low on economic income). Could be criticised as impacting only on debt financed rental housing.	Likely to increase administration and compliance costs in policing new boundaries.	Yes, if desired.	Could be announced with budget, detail design in time for legislation.	Do not progress as "Auckland investment levy" is a better but similar option, and long-run efficiency costs of Interest Levy likely to be higher.
Auckland investment levy (1%). This is an alternative to the mortgage interest levy/partial deduction disallowance, but applies regardless of financing. (Temporary)	Strong – reduce demand for investor housing, reduce prices overall. Lower prices for owner-occupiers, higher rents.	Ongoing shift reducing housing share in investment and increasing in owner-occupied.	To the extent that rental housing is undertaxed, this will promote economic efficiency. Likely to further promote home-ownership beyond existing distortions. If considered a long-run nationwide policy to apply more broadly, could investigate the "risk-free return method" nationwide as a substitute.	Horizontal equity – rental property owners face higher effective tax rate (although effective tax rate is already low on economic income). Some positive equity impacts if set to approximate untaxed capital gains and only applied in Auckland. Option to provide the revenue to the Council (in exchange for them administering it with help from IRD).	Unclear how this option would be implemented. Could be an addition to rates collected by local authority but they do not have information about tenure of housing. Could be opposition from local government. May be able to overcome opposition by promising revenue can be kept by local authority.	Yes, if desired.	Could be announced with budget to apply at a later date if confident the collection issues could be resolved. Need time to develop best collection method (through rates or income tax) and either approach would require lead time to develop. Work on this could, however, be announced in the Budget.	Would need to consult with Auckland Council before deciding feasibility. Consider progressing.

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