The Treasury

Budget 2015 Information Release

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Date: 5 May 2015

To: Minister of Finance
(Hon Bill English)

Minister of Revenue
(Hon Todd McClay)

Deadline: 5 May 2015
(if any)

Aide Memoire: Bright-Line Test Additional Information

At a meeting with officials yesterday, Ministers English, Joyce, and Bennett asked officials to provide additional information on the proposal to apply a bright-line revenue account property test for residential rental property:

- Considerations for whether the bright-line period should be two years or three years;
- A definition of owner-occupied housing that would be exempt from the bright-line test; and
- Considerations for whether the proposal should apply to property purchased from either:
  - The date of announcement of the proposal;
  - The date of introduction of the legislation;
  - The date of enactment; or
  - A set date after the date of enactment.

Period of Bright-Line Test

The intent of the bright-line test is to supplement the current "intention" test for determining when a property is held on revenue account. The concern is that when investors buy and sell a rental property in a short period, they are most likely buying with the intention of resale, but they are not self-assessing on that basis. The bright-line test will supplement the rule with an unambiguous objective test. It will not replace the intention test. A taxpayer will still be subject to tax if they acquire a property with the intention of selling the property and making a gain even if that sale takes place outside the bright-line period.

A question is whether it would be better for the bright-line test to be for a period of two or three years.

Any bright-line test will have overreach and underreach errors. On the one hand it may

pick up gains when there is no intention to sell and make a profit (overreach). On the other hand, it may fail to pick up cases where there is an intention to sell and make a profit (underreach). The longer the period of time for the bright-line test the greater the number of overreach errors and the smaller the number of underreach errors.
The preferred period for the bright-line test will depend on the Government's fundamental objectives. If the Government wants to describe this as a rough justice way of taxing gains when there is a very high likelihood of an intention to sell and make a profit, it is sensible to keep the bright-line period relatively short and limit the overreach. This would be a reason for a two-year bright-line. If, on the other hand, the Government were concerned to strongly limit situations where gains that were initially intended go untaxed, this would be a reason to impose a longer three-year bright-line test and minimise underreach.

This is basically a judgement call but the longer the time period, the more that the bright-line test is likely to be interpreted as a capital gains tax with an arbitrary cut-off period. This will raise questions about why not tax capital gains on other property. It also will put pressure on exemptions or concessions in the general rules.

The possibility of a future withholding tax is another reason why a shorter period may be preferred. Although the design of a withholding tax is still under consideration (eg, whether it applies only to non-resident sellers or to all sellers, and whether certificates of exemption from withholding may be available), application of the withholding tax will impose compliance costs and temporary cash-flow difficulties when it applies (especially in case where ultimately no tax is due so the tax is refunded). Limiting the bright-line period to two years means that withholding will apply less often than it would for a three-year test, especially in cases where ultimately no tax is due so it must be refunded.

Housing Market Analysis

Table 1 shows the proportion of Auckland dwelling sales that are sales of properties purchased within the previous 1, 2 or 3 years. The data shows that 26.1% of sales are sales of properties purchased in the last 3 years. This gives an indication of the amount of transactions that would be taxable under a bright-line test, before excluding those transactions where tax is being paid already, and any exemptions to the bright-line test.

Table 1: Share of Auckland dwelling sales within 1, 2, and 3 years

Sold within	Share of sales	Std error	Confidence interval
1 Year	8.4%	0.2%	8.0% - 8.7%
2 Years	17.4%	0.3%	16.9% - 17.9%
3 Years	26.1%	0.3%	25.5% - 26.7%

Source: MBIE analysis of Corelogic data

The data above are long-run data. MBIE have compared the long-run data with more recent data and found that the more recent data does not indicate an increase in short-term "churning". This suggests that to the extent "churning" is a problem driving the market, it has not increased (and is below the level of churning seen during the mid-2000s house price boom).

From a housing market perspective we lean towards the two-year rule. The two-year

rule deals adequately with any churn issue. Additional transactions caught by the three-year rule are probably having only a limited impact on the market given that localised churn identified by IR data seems to be shorter than two years. Further, the three-year rule will encourage inefficient “lock in” behaviour (holding for the full three years to completely avoid the tax) beyond the “lock in” of the two-year rule.

Finally, our judgment is that the justification of the rule as a substitute for the intention test is strongest when the test uses the two-year time period, as these two-year buy and sell transactions are the ones most likely to have been always intended from the date of acquisition.

On balance officials would recommend in favour of a two year period on both tax policy and housing policy grounds.

Owner-Occupied Housing

An exception to the presumption that the property was bought with an intention of resale is owner-occupied housing, where it is likely to be more common for an owner to have to sell the property in a short period due to a change of circumstances. A major exception to the bright-line test will be the sale of owner-occupied housing.

We consider there should be an easily applied test for owner-occupied housing that is flexible enough to accommodate circumstances of temporary periods of vacancy or rental while the owner is in the process of moving or trying to sell an existing home. At this stage, we are considering a definition such as:

- The property was occupied mainly as the taxpayer’s principal residence from the date of acquisition; and
- If the taxpayer is the trustee of a trust, the above test shall apply by treating the settlor or beneficiary as the owner if they used it as their principal residence (and did not pay rent to the trustee).

Application Date of Regime

The proposal is the bright-line test will apply only to properties purchased on or after the application date (and sold within the bright-line period).

There are at least four possible application dates:

- *date of announcement:* when the policy is announced
- *date of introduction of legislation*: thi*s might be August 2015;*
- *date of enactment of legislation:* possibly November 2015;
- *a later implementation date:* possibly 1 January 2016.

Consultation, Generic Tax Policy Process, and Certainty

The earlier the application date, the quicker its likely effect in reducing speculative demand for housing. At the same time the greater will be the possibility of significant uncertainty, the smaller will be the scope for effective consultation and the more the changes are likely to be criticised as running counter to the Generic Tax Policy Process (GTPP).

If legislation applies before the rules are clear, there will be uncertainty for those who may be subject to the rules. Tax advisors will be unable to advise their clients on what they should do. Inland Revenue considers that there is a substantial risk that it will be unable to provide timely advice to help tax advisors and their clients. It considers that there is a high degree of confidence in the tax policy process in New Zealand because of GTPP and the good consultative process and there is a danger in this being undermined.

There are some complex rules to work through. Capital gains taxes are some of the most complex taxes to enact, and the bright-line test raises many of the same issues, for example:

- Defining purchase and sale;
- How to treat leases and other forms of real property;
- Defining exemptions (owner-occupied, death and inheritance, relationship property transfers);
- How to deal with property held in entities, such as trusts and companies.

Without clear guidance property investors will be unsure how to invest and this could have a greater impact on demand (and liquidity in the property market) then is desirable.

Fairness and Retrospectivity

In addition, good (and expected) practice is that tax changes that are likely to increase taxes should always be done prospectively, that is, to investment made *after* relevant decisions (such as making an investment) are made. This is to avoid any perception of confiscation or arbitrariness by the government.

There are exceptions to this which have been made in exceptional circumstances. For example, a law change to stop oil and gas companies from transferring their foreign oil fields into New Zealand companies to take advantage of generous New Zealand tax rules was made effective from the date of announcement. This is because this became a new tax reduction opportunity that was being taken up quickly and created a large revenue risk. The government felt it had to stop the practice as quickly as possible.

Officials consider that such exceptional circumstances do not apply in this case. The lack of a bright-line (and non-compliance with the intention test) is a long-standing feature, it is not a new revenue risk which requires immediate action to stop revenue loss. Officials consider that it would be best practice to apply the tax prospectively (*after* enactment) as exceptional circumstances to bring the application date forward do not apply.

Market Impacts

The risk from announcing now and implementing later (such as November or January) is that in the intervening period, investors bring forward transactions they were intending to make over the next (say) twelve months. In contrast to this, there is the possibility that investors are deterred from buying now as they will be deterred by additional attention Inland Revenue and the government are applying to this and they know that future buyers (who they rely on for their capital gain) will be subject to the bright-line test.

The transactions brought forward are likely to be:

- Those where investor-buyers always intended to sell within the bright-line test period.

- Those where investor-buyers intended to hold for longer than the bright-line test period, but wanted to retain the option of selling earlier if their circumstances changed.

The first categories are being addressed through audits, and this can be highlighted when announcing the bright-line test. There will inevitably be some people who judge the risk of audits and successful tax assessment to be small and will accelerate early transactions.

The second category of transactions will be brought forward to some degree, but our judgment is that this will not have a large impact on the market. This is because these are investors who intended to buy and hold and so early sale was only a possibility, and many will judge that even if their circumstances do change, they would be able to extend their holding period anyway to avoid the bright-line test.

We do not expect that many people will undertake transactions that they were not already planning or considering. This is because we are **removing** tax benefits that did not incentivise them to invest to begin with. This means that at most purchases will be accelerated in the intervening period, but with no increase in overall demand over the medium term.

Our advice is that market risks can be reduced by emphasising that the government is acting in two distinct ways:

- Adding the bright-line test to apply when the legislation is enacted (November) (Treasury recommendation).

- Giving more funding for property audits that will apply for the coming year and transactions that will have already happened before the test changes.

Any remaining risk from delaying implementation is uncertain when compared to the clear risk from a truncated tax policy process.

This leads Treasury to conclude in favour of delaying implementation until the date of enactment, expected in November 2015. Inland Revenue would have a preference for delaying application until the time when IRD numbers are collected by LINZ so that

package is all introduced at the same time. But it sees November as a possible application date and one which is much preferred to any earlier date.

Application Date	Announcement of Proposal	Introduction of Legislation	Enactment of Legislation
Taxpayer Certainty	Low	Medium	High
Fairness, lack of Retrospectivity	Low	Medium	High
Market Reaction	Immediate reduction in demand due to application of new rules plus uncertainty of application	In period between announcement and implementation - Unclear, some increase in demand from some investors wanting to purchase before the new rules apply to them, and some reduction in demand due to investor concern over attention to this area.	In period between announcement and implementation - Unclear, some increase in demand from some investors wanting to purchase before the new rules apply to them, and some reduction in demand due to investor concern over attention to this area.
Officials Recommendation	Not Recommended		Recommended

A proposal to require IRD and TIN numbers to be provided to LINZ as part of conveyancing transactions is also being worked through and will be discussed in the forthcoming Cabinet paper. This paper will also discuss the possibility of a withholding tax [9]

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