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Cabinet Business Committee

TAXES AND HOUSING

Proposal

1. I propose two measures be announced by the Prime Minister on 17 May 2015 and included in Budget 2015 as part of a housing tax package.
2. Cabinet has previously agreed on an extra \$74 million over 5 years for Inland Revenue investigations in three areas of which 40% (\$29.6M) will be spent on property compliance. Together with the additional money for property compliance investigations, the two additional measures I am proposing will provide a self-reinforcing set of measures which will help the property tax rules to work as intended.
3. These are sensible tax measures in their own right. But they will have the additional benefit of reducing demand pressures on an overheated property market in New Zealand.
4. The two measures are:
 - requiring purchasers and vendors of property to provide their IRD number/s along with the current information requirements prescribed under the Land Transfer Act 1952 as part of the conveyancing process for all real property transfers subject to the Land Transfer Act 1952. In addition, non-resident purchasers and vendors would be required to also provide information on their Tax Identification Number (TIN) in their home jurisdiction as well as suitably robust information concerning identity. This information will be collected by LINZ and provided to Inland Revenue in order to help with the enforcement of tax obligations and to allow for information exchange with overseas tax administrations.
 - a bright-line test to supplement the current intention test which will ensure that, with certain exemptions, gains made from buying and selling a property within a specified period of 2 years will be taxable.

Executive summary

5. This paper proposes two changes regarding real property transactions in order to improve compliance with existing tax rules. The measures will also help at the margin in putting some downward pressure on property prices thereby reducing New Zealand's vulnerability to future macroeconomic shocks and increasing housing affordability.
6. One change will be to require purchasers and vendors of property to supply to the conveyancer their IRD tax numbers, and the foreign equivalent Tax Identification Number (TIN) if a party is non-resident. LINZ will then provide this information to Inland Revenue. This will help Inland Revenue follow transactions and enforce compliance.

7. I propose that this change be advanced by legislation that is passed through all stages under urgency on Budget day that will come into effect on either 1 September 2015 or 1 July 2015.

8. The second change will be to supplement the current tax rules which determine when property sales are taxable by adding a “bright-line” rule that sales of residential property within two years of purchase are taxable. An exception is that this rule will not apply when the sale is of the principal residence of the taxpayer. Most of the sales that will be taxed are probably taxable under the current rules (they were bought for the purpose of resale), but given the difficulty of determining intention and the ambiguity of the current rules the new proposal will be easier to apply.

9. The proposal to introduce a bright-line test is more complex and will take some time to develop. However, I propose to advance it as quickly as possible. This would be:

- a. Announcement of broad policy by the Prime Minister on May 17;
- b. A consultation document to go to the Ministers of Finance and Revenue in June for their approval and to be released to the public in July;
- c. Legislation introduced in August and passed in November; and
- d. The new rules applying to property purchased on or after 1 December 2015.

10. There will be considerable detail on the bright-line test to work through in the consultation period.

Background

11. An overheated housing market, particularly in Auckland, may be increasing New Zealand’s vulnerability to macroeconomic shocks (such as a large downward correction in property prices leading to people having negative equity in their houses and being unable to repay their debts) and also making housing unaffordable to many aspiring house owners.

12. The major way of reducing the overheated Auckland property market and making housing more affordable is to increase housing supply. At the same time there are some tax measures which would assist in this objective while also being consistent with good tax policy principles. The measures proposed in this paper could be presented as part of a wider package of Government initiatives, including supply side measures, that responds to Auckland house price concerns. Other measures for increasing supply that could be part of a wider package include:

- Initiatives aimed at reducing regulatory cost and time – i.e. Auckland Housing Accord and Special Housing Areas, RMA reform;
- 20,000 new dwellings expected to be delivered under the Auckland Housing Accord up to 2018;
- [8]

- Recently announced decisions to transfer HNZN property to the Tamaki Redevelopment Company – which could deliver 5000 additional dwellings over the next 10 – 15 years;
- Engagement with the Auckland Council to explore the potential for joint approaches between the new ‘Development Auckland’ and central government development and infrastructure initiatives.

13. In addition to these Government initiatives the RBNZ is expected to announce in its Financial Stability Report on 13 May that it will consult on changes to its LVR rules. This includes a new LVR for investors in Auckland property of 70%. My proposals will be complementary to that proposal and will better enforce the existing policy to tax those who buy and sell property to make gains.

Comment

14. Cabinet has previously agreed on an extra \$74 million over 5 years for Inland Revenue investigations in three areas: property compliance, aggressive tax planning and the hidden economy (CAB Min (15) 12/4, 20 April 2015). The intention is that 40% (\$29.6M) of this funding will be devoted to property compliance. The additional money devoted to property compliance will help with the enforcement of current rules that require taxpayers who are buying and selling residential property with an intention to sell it and make a profit to pay tax on their gains.

15. The two additional measures I am proposing in this paper will complement the additional investigations money in better enforcing the current property rules. There are:

- requiring IRD numbers to be provided as part of the conveyancing transaction for all property transfers;
- a bright-line test requiring income tax to be paid if residential investment property is bought and sold within a fixed period of two years.

Requiring IRD numbers to be provided as part of the conveyancing transaction for all property transfers

Proposal

16. Under this option purchasers and vendors of any property in New Zealand would be required to provide their IRD tax number/s along with current identity information requirements (such as a passport or driver’s licence to confirm identity) as currently prescribed in the Land Transfer Act 1952 as part of the conveyancing process. This information would be required to be provided to LINZ to effect the transfer of the property. LINZ will provide this information to Inland Revenue.

17. In addition to the IRD number, the conveyancer representing the purchaser and vendor in the conveyancing transaction will be required to collect a non-resident purchaser’s and non-resident vendor’s tax identification number/s (TIN) in their home jurisdiction as well as suitably robust documentation concerning identity and intention (such as a passport or ID card).

18. For both residents and non-residents there will also be a requirement for the purchaser to declare whether their intention is to occupy the property purchased and whether they will hold the property on revenue account. Details here, however, would desirably be consulted on and could be advanced as part of the consultation process for the bright-line test. (If property is held on “revenue account”, it means that gains are taxable and losses are deductible). This information will be provided to Inland Revenue by LINZ and used to determine whether a rental income stream should be expected to be generated from that property. If the purchaser declares that the property to be held is on revenue account this will be relevant as to whether they can claim any tax losses arising on the subsequent sale of the property.

19. At times property will be purchased by a person other than a natural person, such as a trustee. Officials are still exploring how to make the new rules work (eg should the relevant IRD number be that of a trustee, the settlor or some other person) in these cases. These rules need to be worked through with LINZ for the proposed Budget day legislation.

20. Collection of this information may raise some privacy concerns. The information that is passed from LINZ to IRD would only be made available to IRD so that it can enforce tax obligations.

Benefits of this option

21. All purchasers and vendors of property will be required to provide additional information to their conveyancer who will then pass it to LINZ via the property transfer process. LINZ will in turn provide this information to Inland Revenue. This will help Inland Revenue to more easily track and identify property transactions where it is likely that property was purchased with the intention of resale and thus tax is owed on any gain. It will also help Inland Revenue identify properties where rental income should be expected to be returned; and 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.

22. By requiring non-residents to provide their foreign TIN we will also be able to support other jurisdictions in their tax compliance activities. This is part of our exchange of information obligations under our tax treaties we have with other jurisdictions. The intention is for Inland Revenue to spontaneously share this information with other agencies on a regular basis. Collection of the TIN number will also help in providing information on the proportions of properties purchased by residents and non-residents.

Timing of changes and legislative vehicle

23. To impose the requirement for IRD and TIN numbers to be provided it will be necessary for legislation to be enacted. For those without IRD numbers (for example, non-residents) no new legislation is required in order for Inland Revenue to provide these numbers. Currently Inland Revenue is able to normally respond to requests within 5 days. However, this timeframe may be longer if volumes increase significantly in the short term. I would like to signal the direction of changes as soon as possible.

24. I note, however, that legislating on Budget day would not allow for any opportunity for consultation with conveyancers or the public on the changes. LINZ has a concern that this may lead to bad legislation that needs to be fixed up later.

25. Another possibility is to require non-residents acquiring property to have a bank account so that the current anti-money laundering (AML) rules apply. The current AML rules are quite stringent so this would be a robust way of acquiring additional information on non-residents purchasing property. There would be some additional compliance costs but these are likely to be minor relative to the costs associated with purchasing property.

26. Officials advise this would be best considered with the benefit of consultation with other agencies including the Reserve Bank, the Ministry of Justice and the Department of Internal Affairs. This would desirably require a longer timeframe than Budget day legislation. I propose that officials be directed to develop such an option and it could be consulted on as part of the new bright-line test rules covered below.

Implementation

27. If legislation is passed on Budget day to require purchasers of property to provide an IRD number and TIN number as part of the property conveyance transaction. This could come into force for all property transactions from 1 September 2015. This will allow Inland Revenue and LINZ to have implemented IT systems to collect and exchange the information. This timeframe will also allow non-resident purchasers and vendors to apply for an IRD number. Furthermore, it will allow some time for education for conveyancers on the new requirements. It would be possible for the legislation to come into force earlier, say 1 July 2015, but this would require a transitional manual system operating for 2 months. Inland Revenue, LINZ and Treasury officials have advised that their recommendation is an application date of 1 September 2015 to avoid unnecessary transitional change.

Market impact

28. The collection of IRD and TIN numbers will help Inland Revenue and other tax authorities enforce tax rules. It will also provide useful information on who is buying and selling property. But it is also likely, once the new requirement is in place, to have some effect on the overall housing market in dampening demand for houses as a result of better enforcement of the tax rules.

29. There is a possibility that between the time that the new requirement is announced and when it is implemented there is an increase in numbers buying houses and especially foreign purchasers in a rush to beat the new requirements. This could potentially lead to a short-term increase in demand putting upward pressure on prices. However, we think the risk of this happening is small. The big news is likely to be that the Government is stepping up information requirements and enforcement in this area. Also the collection of IRD numbers from vendors as well as purchasers will be helpful in this regard. The fact that the TIN number will be required for future sales is likely to produce an immediate downward pressure on demand.

Compliance cost impact

30. Clearly the measure will increase the compliance costs on those undertaking property transactions. In practice, the impact on individuals purchasing a home will be small as the vast majority of people purchasing property will already have an IRD number and the costs associated with requesting a number are minor. The primary increase in costs will be imposed on non-residents required to provide their TIN at the time of applying for an IRD number and providing their TIN again when purchasing property. Conveyancers will have a

small increase in data entry costs and will have to ask for extra details from the purchasers and vendors of a property.

A bright-line test requiring income tax to be paid if residential investment property is bought and sold within a fixed period of two years.

Proposal

31. The intent of the bright-line test is to supplement the current “intention” test. Gains on property are currently legally taxable when property is bought and sold with the intention of making a profit but this rule is hard to enforce because it is difficult for Inland Revenue to determine intention. The concern is that when taxpayers buy and sell a residential property in a short period, they are often most likely to be 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.

32. The proposal is to tax all gains on residential property that is sold within two years of purchase unless the property was mainly used as the principal residence of the taxpayer. Properties owned by a trust will fall within the exemption 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).

33. The bright-line test helps address the subjectivity of the current intention test in the land sale rules. It creates a clearer rule that supplements the intention test and makes it easier to enforce. It ensures that persons who turn properties over quickly are taxed on their gains. However it needs to be recognised that a bright-line test is quite a blunt instrument and will inevitably have an element of rough justice.

Design issues

34. There are a number of important design issues that need to be worked through and would benefit from public consultation before Ministers make their final policy decisions.

35. The issues include:

Definition of principal residence

36. The proposal is that the bright-line test should not apply when a taxpayer’s principal residence is bought and sold within a two-year period. The intention would be to catch sales of other property including second houses and baches as well as property that is bought and sold off plans prior to any construction taking place.

37. An obvious risk is potential confusion for taxpayers given the Reserve Bank will be applying its LVR rules to investors but not to owner occupiers. There will be considerable cross over between the people that are left out of the LVR restrictions and the people who are exempted from the bright-line test.

38. The different objectives for the Reserve Bank’s LVR and the bright line test mean they will apply in different circumstances. The Reserve Bank test was aimed at responding to a financial stability concern and particularly risks associated with highly-g geared investors

acquiring rental properties. The bright-line test is targeted at those who are buying and selling property over short periods of time and sidestepping the current intention test. This includes those who may have no mortgage, and both non-residents and residents who have may no intention to generate any rental income from a property. It includes people who are buying and selling properties off plans prior to construction.

39. The Minister of Finance will provide an update to Cabinet on this point.

Types of land covered

40. The bright-line test could cover all land or just residential land.

41. Although covering all land would reduce issues around the boundary between residential land and other land, covering only residential land ensures that the policy is targeted at the main concern of high churn of residential property in conjunction with the subjectivity of the current intention test.

42. Therefore, I recommend that the bright-line test be directed only at residential property. Officials advise that the boundary between residential and other land can be drawn with sufficient certainty to ensure the test is robust.

43. The bright-line test would apply to empty land zoned for residential purposes. This is necessary to ensure the test achieves its objective of targeting short term churn of residential properties, some of which includes properties that are not yet built that are bought off the plans. Developers will already be subject to tax on their gains under current rules.

Land-rich companies

44. The current land sale provisions can be circumvented by holding land in a company and selling the shares in that company rather than the land itself.

45. It is important that people cannot readily avoid the bright-line test. Therefore, one of the design issues with the bright-line test is whether it should extend to the sale of shares in land-rich companies.

46. Officials note that this could be an issue across all the land sale provisions and arguably should be dealt with comprehensively rather than for the bright-line test only. In addition, this is a highly technical issue and consultation is desirable to avoid unintended consequences. Even if the new rules only apply from 1 December 2015 it may be necessary to consider any amendments in this area as a second stage task after the bright-line test comes into force. Officials are working through this issue.

Land held by trusts

47. If a trust sells property within two years of purchase it would be covered by the bright-line test and be taxable. But sometimes a principal residence may be held in a trust. I propose that the owner-occupier exclusion apply to family homes held in trusts.

Exemptions from the two-year rule

48. The bright-line test will inevitably have a measure of rough justice about it. In order to be effective the numbers of exemptions should be as few as possible and tightly defined. The

worst possibility is to put in place a tax which creates compliance costs but can be easily circumvented. However, I consider that some exemptions are justified where there is no reason to believe that the short term turnover of the property would be associated with any intention to make a profit. The two exemptions I propose are inheritances and relationship property settlements.

49. It should be noted that a principal residence that is sold to a new purchaser may, at times, be rented out to the new purchaser for short periods. It is important that the bright-line test does not get in the way of legitimate purchases and sales of a principal residence. Providing an exemption for property that is mainly used as a principal residence should adequately cover this situation in the vast majority of cases.

50. It should be noted, that the exemption would not extend to second homes or baches which are bought and sold within in the bright-line time period. The intention is to include gains on these properties within the net.

51. There are hardship provisions in the tax legislation addressing situations where payment of tax could cause serious hardship. I do not propose a specific exemption from the bright-line test on grounds of hardship. Tax will be levied on a property sale within two years only when a taxpayer has made a gain. Hardship considerations are most pressing when taxpayers have made a loss. Special hardship provisions are not required. Taxpayers will be able to access the normal hardship rules when this is appropriate.

Losses

52. The issue of any losses arising on the sale of a residential property under the bright-line test needs to be addressed. If losses were deductible within the 2-year bright-line period, there would be an opportunity for taxpayers to cherry pick. If properties had fallen in value over the period, there would be incentives to sell immediately before the bright-line period ends so the taxpayer could claim a deduction. If, on the other hand, properties had risen in value there would be incentives to sell immediately after the bright-line period ends if the taxpayer thinks that this means that the gain will be exempt.

53. One way of dealing with this would be to disallow any deduction for losses. But this seems asymmetric and unfair. An alternative which is being considered is to allow taxpayers to register whether they intend to sell the property and make a gain at the time that the property is acquired. Losses could be deductible only for those who have made this election. The deduction could be allowed whether or not the property was sold within the bright-line time frame. But the flipside would be that anyone who has made such an election would be subject to tax on any gains whether or not the property is sold beyond the bright-line time period.

54. This requires people to notify Inland Revenue at the time they purchase the property that they intend to hold the property on revenue account. This notification could sensibly be made as part of the conveyancing transaction and form part of the information provided to the conveyancer before the title is issued by LINZ, as with the proposal above to require the provision of the IRD number as part of the conveyancing transaction. Officials are exploring this option.

Market impact

55. 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 show that 17.4% of sales are sales of properties purchased in the last 2 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 in the bright-line test. The possibility of extending the bright-line period to 3 years was considered but rejected. This would have been likely to have captured significantly more sales including those where there was no initial intention to sell and make a gain.

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

56. 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”.

57. While the main motivation in the bright-line test is making current tax rules work better, there will also be implications for the housing market.

58. In the longer term, the bright-line test may put some downward pressure on property prices but this effect is expected to be relatively small. Supply-side factors are likely to be much more important.

59. In the shorter term, given the overheated market in Auckland, the changes could have a more material signalling impact. At the same time, there is a small risk that announcing the test before implementing it will cause people to bring forward purchases ahead of the time that the test applies. However, this will be mitigated by the fact that the Government is clearly focussing on property compliance and the additional audit resources for property compliance will help in enforcing the current intention test. Thus, any who rush in to buy and sell a property before the bright-line test comes into force are likely to be subject to the intention test. Announcing the test prior to application is necessary for there to be consultation with taxpayers and their advisors on the new test. This is very important if the rules are to work well.

60. Therefore it is my recommendation that we implement any changes after the legislation is enacted. An application date of 1 December 2015 is envisaged.

Withholding tax

61. [9]

62. A way of addressing this is to require a withholding tax to be collected at the time of the sale.

63. Inland Revenue officials are exploring the possibility of a stand-alone commercial off the shelf (COTS) product for Inland Revenue to administer such a withholding tax, and whether this could be available early next year. An open question which is being worked through is whether any withholding tax should apply only to non-residents or to both residents and non-residents.

Timing and application date

64. The proposed time frame for the bright-line tax change is as follows:

- the Prime Minister announces a two-year bright-line test on 17 May 2015 with an application date of either 1 December 2015 (Treasury and Inland Revenue preferred option) or the date of introduction of the legislation;
- officials prepare a consultation document for approval by the Ministers of Finance and Revenue in June 2015;
- consultation is released publicly in July 2015 with a short period (no longer than 3 weeks) for submissions;
- new legislation is introduced in August 2015 with a truncated legislative process;
- new legislation is enacted in November 2015;
- new legislation applies from either 1 December 2015 or date of introduction of the legislation.

[8]

Consultation

66. Treasury has been involved in the preparation of this report. Officials have also consulted LINZ and informed PCO about the proposals.

Financial implications

67. The main fiscal impact of the housing package relates to the additional appropriation for property compliance. The extra funding of \$29.5 million over 5 years is expected to return \$8 for every \$1 spent. This is a net fiscal gain of approximately \$207 million. The fiscal impact of this change has already been reflected in the Budget 2015 Budget Package for Vote Revenue agreed by Cabinet on 20 April 2015. Obtaining IRD and TIN numbers will also

help enforcement in relation to gains from property and also rental streams which will increase revenue, but the quantum is too uncertain to estimate.

68. By comparison, the bright-line test is likely to provide relatively minor amounts of revenue. A static costing (assuming full compliance and no change in behaviour) of the bright-line test is that it would generate approximately \$30 million to \$40 million per year in revenue. However, we expect significant behavioural change in terms of fewer people buying for speculation and selling within two years (this is an intended effect). [9]

We therefore estimate this as a \$5 million revenue gain per year from the 2016-17 income year (assuming a 1 December 2015 application date).

Legislative implications

69. Amendments to the Land Transfer Act 1952 will need to be made prior to the application date of 1 September 2015 or 1 July 2015. I propose that these amendments be introduced into the House and passed through all stages under urgency on Budget Day. Amendments to the Income Tax Act will need to be enacted prior to 1 December 2015. I propose that a bill be introduced in August and progressed under a truncated process.

Regulatory impact analysis

70. The regulatory impact analysis (RIA) requirements apply to this paper but a RIS has not been provided. The RIA team at Treasury considers that the impacts (most directly on the behaviour of purchasers and vendors) are likely to be significant. On that basis, Cabinet's requirements and the quality assurance criteria for regulatory proposals have not been met. A RIS should be prepared as soon as possible to inform consultation. A RIS will be prepared before final Cabinet decisions on the design of the a bright-line tax regime which are expected before the bill is to be introduced in August.

Publicity

71. The Prime Minister will announce details of the tax package on 17 May 2015.

Recommendations

72. I recommend that Cabinet:

1. **note** that Cabinet has approved an additional appropriation of \$74 million over five years to Inland Revenue for extra investigations in three areas, one of which is property compliance;
2. **approve** a requirement for IRD and TIN numbers to be provided by purchasers and vendors of real property when land is transferred on or after either :
 - a. 1 September 2015 (Treasury, Inland Revenue and LINZ preferred option); or

- b. 1 July 2015 (note this application date will involve a transitional manual system for 2 months).
3. **approve** an amendment to the Land Transfer Act 1952 to be passed through all stages under urgency on Budget day to give effect to recommendation 2;
4. **agree** that legislation be provided to Cabinet for their approval on 18 May 2015;
5. **agree** that the Ministers of Finance and Revenue be given authority to approve the details of legislation;
6. **approve** a bright-line test to supplement the current intention test under which residential property bought and sold within two years will be subject to tax unless the property is the principal residence of the taxpayer;
7. **agree** that the new bright-line test apply to properties purchased on or after either:
 - a. 1 December 2015 (Treasury and Inland Revenue preferred option); or
 - b. the date that legislation is introduced.
8. **direct** officials to develop a withholding tax [9]
9. **direct** officials to develop a proposal requiring non-resident purchasers of real property to open a New Zealand bank account so that the AML provisions apply;
10. **agree** to the Prime Minister announcing details of this package on 17 May 2015;
11. **agree** that the Minister of Revenue and the Minister of Finance be given joint authority to agree on the details of the package that will be put forward in a consultative document;

[8]

Hon Todd McClay
Minister of Revenue

____ / ____ / ____
Date