

Coversheet: Tax measures to moderate house price growth – extension of the bright-line test

Advising agencies	<i>The Treasury</i>
Decision sought	<i>Agree to extend the bright-line period for property acquired on or after the application date.</i>
Proposing Ministers	<i>Minister of Finance Minister of Revenue Minister of Housing</i>

Summary: Problem and Proposed Approach

Problem Definition
What problem or opportunity does this proposal seek to address? Why is Government intervention required?

The Government’s objective is to support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers.

Access to affordable housing is important to support the living standards of New Zealanders. Rates of homeownership have reduced significantly from their peak in the 1990s, particularly for younger people, increasing intergenerational inequity.¹ Investors account for a significant portion of house purchases, reducing the number of houses available for new owner-occupiers. Rising housing costs are also having an impact on renters.²

While the tax system is not the primary driver of housing affordability, current tax settings incentivise investment in housing. This is because a significant source of economic income from residential property, capital gains, is not fully taxed.

This creates equity issues compared to earnings from salary and wages, which are fully taxed. Not fully taxing some economic income from property investment encourages inefficient investments (compared with other possible investment options), with flow-on impacts for the housing market.

Summary of Preferred Option or Conclusion (if no preferred option)
How will the agency’s preferred approach work to bring about the desired change? Why is this the preferred option? Why is it feasible? Is the preferred approach likely to be reflected in the Cabinet paper?

An options analysis would consider different ways to more consistently tax income. However, the Government has ruled out new taxes or taxes on the family home. The Government has also ruled out comprehensive taxation of capital gains or a risk-free return method tax.

1 Stats NZ, data from 1916-2018 Censuses. <https://www.stats.govt.nz/news/homeownership-rate-lowest-in-almost-70-years>

2 HUD analysis and CoreLogic (monthly)

This Regulatory Impact Statement has been produced under extremely tight time constraints without consultation or the benefit of robust data, and accordingly there is a risk that the analysis is incomplete or may miss key interactions. It represents the Treasury's best assessment of the options identified by the Government in the time available.

Bright-line test extension

In light of the Government's objectives and the above constraints, on balance the Treasury's preferred option is an extension of the bright-line period from 5 years to 20 years with no exemption for new builds.

While tax settings are not the primary driver of problems in the housing market, extending the bright-line test should put downward pressure on house prices in the short to medium term, and provide equity and efficiency benefits in taxing more economic income. However, extending the bright-line test may put upward pressure on rents.

While the extension may result in lock-in effects, the additional costs of these are unclear. The Treasury's view is that lock-in will not significantly reduce housing utilisation.

Therefore, the Treasury considers the measure improves the tax system on balance and contributes to the Government's stated demand-side housing objectives: to support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers.

The Treasury's preferred option is a 20-year bright-line test, however it also considers a 15-year bright-line test is superior to the status quo, as it would help meet some of the Government's housing market objectives - but not to the same extent as a 20-year bright-line test. In the time available, the Treasury has not formed a view on whether a 10-year bright-line test is preferable to the status quo.

The Treasury does not recommend providing an exemption from the extended or existing bright-line test for early investors in newly constructed homes. An exemption comes with additional administrative and compliance costs, and over time reduces the coherence of the tax system. While increasing housing supply is important, the Treasury considers there are likely to be better ways to directly support supply, for example through an explicit subsidy for developers. If the Government does proceed with an exemption, the Treasury prefers that exempt houses remain subject to the 5 year bright-line rule.

Interest deductibility

Given time constraints and lack of analysis, the Treasury does not recommend progressing the interest deductibility proposal without further analysis. The Treasury recommends further regulatory impact analysis and consultation be undertaken before final decisions are made on this measure.

This Regulatory Impact Statement addresses the extension to the bright-line test only.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?

Bright-line test extension from 5 to 20 years (no new build exemption)

The main benefit of the proposal is distributional. The primary beneficiaries of extending the bright-line period are new owner-occupiers, to the extent these measures result in lower house prices than otherwise. The distributional benefits will also depend on the use of additional Crown revenue to the extent that additional tax is paid as a result of these measures.

There are also wider system benefits: efficiency increases as more economic income is taxed, and 'lock-in' impacts are potentially mitigated around the five year mark; horizontal equity improves as the tax treatment of capital income is brought into closer alignment with labour income; and vertical equity improves as the progressivity of the tax system increases.

These benefits would arise to a lesser extent with a bright-line extension to 10 or 15 years. A shorter extension is likely to reduce lock-in around the 5-year mark less, but create less lock-in for houses held for longer periods.

Where do the costs fall?

Bright-line extension from 5 to 20 years (no new build exemption)

The costs of extending the bright-line period to 20 years fall primarily on residential property investors and potentially renters, although there is considerable uncertainty about the magnitude of the impact on rents. These costs would be less for a shorter extension.

To the extent that house prices are lower than otherwise, the costs would fall on existing residential property investors. Expected after-tax returns are not expected to change for new residential property investors, although investors may face a higher than expected ex-post tax liability for selling within the period if there are unexpected capital gains.

To the extent that rents are higher than otherwise, the costs would fall on renters who do not purchase a home. This would disproportionately affect low-income households, younger people, Māori, and Pacific peoples. Extending the bright-line could decrease the supply of rentals over the long-term. There are many factors affecting rents beyond rental supply, including renters' income levels. This means the impact an extension will have on rents is difficult to quantify, but there is a risk there could be upward pressure.

There would also be additional compliance and administrative costs to the extent that more taxpayers are captured by the bright-line extension.

Lower house prices than otherwise would also reduce the housing wealth of existing housing owner-occupiers. However, this would not necessarily have direct impacts on their consumption, although it may have impacts for those that wish to reduce their housing consumption (as they would realise less wealth from down-sizing).

What are the likely risks and unintended impacts? How significant are they and how will they be minimised or mitigated?

There is a general risk associated with analysing the impacts of this measure in a condensed timeframe and in isolation from the supply-side proposals being considered by

the Government. These interventions are complex, and their interactions are liable to produce unforeseen outcomes.

Bright-line extension:

Lock-in effects

Extending the bright-line test would impact the 'lock-in' effect for properties held for a longer period, compared with the status quo. The lock-in effect refers to the incentive investors have to hold onto property until the bright-line period has expired to avoid a tax liability. In theory, the lock-in effect reduces housing liquidity.

The strength of the lock-in effect increases with a longer bright-line period, because the potential capital gain would be relatively larger. However, a longer bright-line period would reduce lock-in in the early years as compared to status quo (or a shorter period), as people may be less willing to hold onto the property for a much longer period. Due to these competing effects, it is not possible to say what period minimises lock-in.

While on balance, we do not expect lock-in to have a significant impact on housing utilisation, there is a risk that extending the bright-line could lead to a more significant lock-in impact than anticipated and/or greater economic costs than anticipated.

Long-run supply issues

Extending the bright-line period may lead to fewer houses being built in the long-run than otherwise would be under the status quo. There is a risk that any decrease in supply will partially or fully offset the extension's short to medium-term decrease in house price growth over the long-term. Higher prices from lower supply diminishes the measure's benefits to new owner-occupiers, and lower rental supply potentially increases rents.

Rental market affordability

Any reduction in the supply of residential rental properties, due to the reduction in investors buying and renting out property, may put upward pressure on rents. It is possible that a higher level of homeownership among former renters does not completely offset the pressure on rental prices, as owner-occupiers may have smaller households. Alternatively, to the extent that rents are set by income levels, they may not increase.

Bright-line extension (new build exemption):

Exempting new builds from an extended bright-line test could go some way to mitigating the risks associated with an extension. Most of the risks associated with a bright-line extension relate to the uncertainty around the magnitude of the extension's costs and benefits, and any impacts on supply and rents. An exemption mitigates these risks by weakening the costs and benefits, meaning an extension with an exemption would produce an outcome closer to the status quo than an extension without an exemption.

This comes at the cost of lower expected benefits, and additional compliance and administrative costs.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?

There is a low rating of evidential certainty. This analysis has been prepared under significant time constraints and faces substantial data limitations. There are complex interactions between potential measures that have not been analysed.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:

The Treasury’s Regulatory Impact Analysis Team and Inland Revenue have reviewed the Regulatory Impact Statement (RIS) “Tax measures to moderate house price growth – extension of the bright-line test” produced by the Treasury and dated 5 March 2021.

Quality Assurance Assessment:

The review panel considers that it **partially meets** the Quality Assurance criteria.

Reviewer Comments and Recommendations:

While realising that the tax system is not the primary driver of housing affordability, the Treasury has identified a number of options to help partially address the housing problem. The Treasury’s preferred option is to extend the bright-line test from 5 years to 20 years with no exemption for new builds. A framework with a comprehensive set of criteria has been developed to assess these options. However, limited consultation has been undertaken due to significant time constraints.

The denial of interest deductions is another policy option that has been identified, but in the time available, the Treasury has not been able to undertake impact analysis. Further, no analysis has been undertaken on how this measure would interact with the extension of the bright-line test. The Treasury has agreed that a Supplementary Analysis Report (SAR) relating to this proposal will be incorporated into an upcoming consultation process. After this consultation, a full RIS will be produced for the final policy decision at the Cabinet.

Impact Statement: Tax measures to moderate house price growth – extension of the bright-line test

Section 1: General information

1.1 Purpose

The Treasury is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing key policy decisions to be taken by Cabinet.

1.2 Key Limitations or Constraints on Analysis

Limited options:

The analysis is limited by the tax options already ruled out by the Government, including a comprehensive capital gains tax, a tax on a deemed rate of return for residential property, a wealth tax, or any new measure outside of the current tax framework.

The options analysed in this Regulatory Impact Statement are at the direction of Ministers.

Supply-side measures:

The Government intends to progress a complementary set of supply-side measures which are expected to increase housing supply and lower rents. The impacts of these supply-side measures have not been included in the impact analysis in Section 4. As a result, the impacts of the demand-side tax measures have not been considered in the context of any supply-side measures.

Significant time constraints:

This analysis has been prepared under significant time constraints. Accordingly, elements of the analysis might not be sufficiently robust. Due to time constraints, there has been no opportunity for consultation with external stakeholders.

Lack of empirical data:

This analysis on what impact this initiative will have on the housing market is constrained by a lack of empirical data. Where evidence is not available, a theoretical assessment of the expected impact has been provided. While some empirical data is available from the current application of the bright-line test, it is difficult to isolate the impact of that policy change from other influences on the housing market over the relevant time period.

Projected revenue:

Revenue impacts from the bright-line extension have been undertaken through static analysis, given it is not possible to estimate the behavioural impacts of the measure. Examples of unknown behavioural effects are how many people would sell within 5 years or, after 20 years, how much lock-in would occur over the long-term, and the size of the reduction in the rental property market.

1.3 Responsible Manager (signature and date):

Jess Rowe

Tax Strategy

Economic Systems Directorate

The Treasury

05/03/2021

Section 2: Problem definition and objectives

2.1 What is the current state within which action is proposed?

Access to affordable housing is important to support the living standards of New Zealanders

Housing supports many of the wellbeing domains identified in the Living Standards Framework, and plays a role in determining New Zealand's physical, social, and human capital stocks. High-quality housing stock provides shelter, protection from the elements, personal space, security, and privacy. Suitability, affordability, and quality of housing are likely to be influenced by housing affordability.

Affordable housing is an important factor in determining people's wellbeing, particularly for low-income families where housing costs represent a higher proportion of total income. High housing costs relative to income, poor housing quality and insecure tenure worsens child poverty, health outcomes and homelessness.³ Renters generally live in poorer-quality housing that is more likely to be cold, damp, have mould, and need major repairs.

Home ownership in and of itself has long-term impacts on living standards and the distribution of wealth accumulation; New Zealand homeowners are typically 14 times wealthier than non-homeowners.⁴ Furthermore, unaffordable housing disproportionately affects some population groups including low-income people, younger people, Māori, and Pacific peoples.

Housing affordability has been declining

Affordability for owner-occupiers

Housing costs compared to income are high in New Zealand compared to other OECD countries.⁵ Nationally, house prices have been rising at a rate faster than wages over the past five years.⁶ This trend has accelerated over the past year. House prices have

3 Treasury analysis

4 Stats NZ, Housing in Aotearoa: 2020, pp 47. <https://www.stats.govt.nz/assets/Uploads/Reports/Housing-in-Aotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf>

5 OECD Better Life Index (2020). <http://www.oecdbetterlifeindex.org/topics/housing/>

6 Stats NZ, Housing in Aotearoa: 2020, pp 48, Figure 35. <https://www.stats.govt.nz/assets/Uploads/Reports/Housing-in-Aotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf>

increased 19.8 percent year-on-year to October 2020, with the median price at that time being \$725,000.⁷ Auckland's median house sale price for October was over \$1 million for the first time.

Homeownership rates are significantly lower now than they were at their peak in the 1990s and, as at the 2018 Census, were at their lowest since the 1950s.⁸ However, home ownership rates have remained relatively stable over the last 5 years, which may reflect first home buyers taking advantage of KiwiSaver deposits and low mortgage interest rates to enter the market. The decline from the 1990s in the proportion of households living in owner-occupied homes did not occur uniformly across the population and declined at a faster rate for Māori and Pacific peoples. For Māori the proportion of people living in an owner-occupied home declined across most of the 20th and early 21st century. Since 1991 it has fallen from 57.4% to 47.2% by 2018. For Pacific people it has dropped from 50.8% in 1986 to 35.1% in 2018.⁹ There are also considerable disparities in homeownership rates by age, with homeownership rates higher for older people.¹⁰

Housing investors have consistently accounted for over one-third of property purchase transactions over the past decade, with investors making almost 40% of purchases in September 2020. Investor bidding is likely to exacerbate price escalation and hinder the ability of owner-occupiers to purchase houses.

Affordability for renters

Housing unaffordability tends to be more pronounced for renters than owner-occupiers. In 2019, approximately one third of households were renters. This was more pronounced for lower income households with nearly half of all households in the lowest income decile renting. In 2020, 45% of renters spent 30% or more of their income on housing costs compared to 25% for owner-occupiers.¹¹ This high ratio of rents to incomes has been steady nationally for more than a decade. However, rents have grown much faster than incomes for some groups, including low-income renters, beneficiaries, and renters in major centres (such as Auckland and Wellington) and in some regions (such as Bay of Plenty, Taranaki and Gisborne). Several factors explain increasing rent prices including the cost to supply rentals and incomes.

The drivers of unaffordability are multifaceted and complex

Supply issues

Restrictions on the ability to increase housing supply in the short term mean that demand bids up the price of existing housing stock rather than contributing to greater housing construction in the short term. Such restrictions include regulatory barriers (e.g. zoning and height restrictions), increasing costs of building, and a lack of long-term infrastructure planning. Contributing to the lack of planning is local councils' limited access to financial capital.

As a result of these supply-side restrictions, increases in housing supply has not kept up with increases in demand over the last 40 years. Estimates of the shortage range between 40,000 and 130,000 houses.¹²

7 REINZ Monthly Report October, pp 6. (Released 12 November 2020)

8 Stats NZ, Housing in Aotearoa: 2020.

9 Stats NZ, Figure 16 of Housing in Aotearoa: 2020.

10 Stats NZ, data from 1916-2018 Censuses. <https://www.stats.govt.nz/news/homeownership-rate-lowest-in-almost-70-years>

11 Stats NZ, Housing in Aotearoa: 2020.

12 <https://www.infometrics.co.nz/nz-short-by-nearly-40000-houses/> and Kiwibank analysis

Demand issues

Demand side factors are also putting upward pressure on prices. Falling interest rates have resulted in an increase in house prices, creating capital gains for existing property owners but worsening the position of prospective first home buyers. The removal of loan to value ratio (LVR) restrictions by the Reserve Bank of New Zealand in response to COVID-19 allowed highly-leveraged investors to re-enter the market, exacerbating price pressures. High population growth has also increased demand for housing over recent decades.

While tax settings are not the primary driver of housing affordability, current tax settings incentivise investment in housing. In the context of constrained supply, lightly taxing housing relative to other forms of income will lead to higher property prices than would otherwise be expected.

2.2 What regulatory system(s) are already in place?

Taxation of residential rental housing

Income generated from renting residential houses is subject to income tax. That is, the gross rental less expenses (including interest) is taxed at the investor's marginal tax rate. Losses from rental property are ring-fenced, which means they can only be used to offset income from residential property, not the taxpayer's other income such as their salary and wages.

Taxation of capital gains from residential housing

There are a number of tax rules that determine whether the capital gains from the sale of property are taxable. For example, gains from the sale of residential property will be taxable if the purchaser acquired the property with the intention of disposing of it, or if they are engaged in regular property trading and/or development pattern.

A 5-year bright-line test for the taxation of residential investment property is already in place. The policy intent was that the bright-line period would act as a proxy for determining intent – that is, if someone purchases a property and disposes of it within a short period, it was likely that their intent when purchasing the property was to dispose of it.

For properties purchased on or after 1 October 2015 through to 28 March 2018 (inclusive), the bright-line rule applies to residential properties bought and sold within two years. Since 29 March 2018, any residential property bought and sold within five years is taxable.

The rule applies subject to some exemptions. The bright-line test does not apply to sales of the main residence (owner-occupiers). The only other exemptions are for inherited property and rollover relief for certain transfers of relationship property.

There are concerns about compliance with the existing bright-line test. Inland Revenue uses an analysis of Land Information New Zealand (LINZ) tax statement data compared to tax return information to approximate levels of compliance with the bright-line test.

Compliance levels are constantly changing as annual interventions are carried out including marketing, education, returns policing, direct mail-outs, community compliance visits and audits. From March 2021, all customers who have sold a residential property within the bright-line period will receive a letter advising them of their potential obligation and providing resources for them to assess their situation.

2.3 What is the policy problem or opportunity?

The cost of buying a house is placing significant financial stress on households and having perverse effects on equity (including intergenerational equity). House prices compared to income in New Zealand are high by international standards and have increased further over recent years. Rates of homeownership have declined significantly since the 1990s. As noted above, this impacts people's living standards.

The Government is also looking at a package of supply-side measures to address housing affordability in the long term. However, these measures will take some time to have an impact. To the extent that housing affordability concerns are due to excess demand and some of this demand is from investors, then reducing demand from investors may result in less upward pressure on house prices.

While the tax system is not the primary driver of housing affordability, features of the tax system exacerbate the issue. In particular, investment in housing is tax-preferred as compared to investments that do not earn large capital gains. This creates an incentive to invest in housing over other asset classes and puts further upward pressure on property prices.

2.4 What do stakeholders think about the problem?

The key stakeholders are: residential property investors / landlords, renters, first home buyers, owner-occupiers, other stakeholders with interests in macro-financial stability (including banks), non-government organisations and regulatory agencies. There are varying views from stakeholders as to the relative importance of supply side and demand side factors.

Due to time constraints, there has been no opportunity for consultation with external stakeholders on the proposal to extend the bright-line period or exempt new builds.

Inland Revenue and the Ministry of Housing and Urban Development have been involved in the development of this policy and were consulted in the preparation of this Regulatory Impact Statement. Their views are summarised below.

Inland Revenue view:

Inland Revenue recommended against both extending the bright-line and denying interest deductibility.

With the bright-line extension, a key concern is that many investors might pay substantial amounts of tax if they sold properties within 20 years but receive the gains tax free if they held the properties for longer period. Inland Revenue considered that this would have a substantial "lock-in effect" encouraging people to hold on to properties even if this would not otherwise be sensible. This is likely to impede property from being used in the highest value ways. Also, the 20-year extension is likely to add to compliance costs. Higher compliance costs and economic inefficiencies through lock-in effects might be viewed as a natural consequence of raising tax. But they are likely to be particularly inefficient if, often, no tax ends up being raised because properties are held for more than 20 years.

If this measure were to be introduced, Inland Revenue considers that there is a good reason to exempt new builds to minimise adverse impacts of the measures in reducing the supply of new housing.

However, Inland Revenue recommends that in the context of the bright-line test, the exemption should only be from the extension and not from the application of a bright-line

test altogether. Such properties are currently subject to the 5-year bright-line test under the status quo and building consents are at an all-time high. A full exemption would create an incentive for speculation in the market for new builds, placing further upward pressure on prices. There are further administrative concerns as it would increase reliance on other aspects of the land sale rules in the Income Tax Act, including the intention test, which is subjective in nature and difficult to administer for a large group of taxpayers.

Ministry of Housing and Urban Development view:

The Ministry of Housing and Urban Development supports either a full exemption or a partial exemption (ie, existing 5 year bright-line continues to apply) from the extended bright-line test for new builds to mitigate the impact on the new supply of housing. Maintaining and increasing new supply is critical to addressing housing affordability in the medium term. The Ministry is concerned about the potential impact that extending the bright line test could have on demand for new builds, construction sector jobs, and decreased investor willingness to invest in Build to Rent.

In the absence of clear information about the effectiveness of an exemption, the Ministry of Housing and Urban Development would err on the side of supporting new supply and the continued growth in construction jobs which has partially offset job losses in other sectors and supported the economic recovery.

2.5 What are the objectives sought in relation to the identified problem?

As noted on 15 February 2021 (CAB-21-MIN-0018 refers), Cabinet's policy objectives for the housing market are to:

- Ensure every New Zealander has a safe, warm, dry, and affordable home to call their own – whether they are renters or owners.
- Support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers.
- Create a housing and urban land market that credibly responds to population growth and changing housing preferences, that is competitive and affordable for renters and homeowners, and is well-planned and well-regulated.

The intervention identified in this Regulatory Impact Statement seeks to address the Government's demand-side housing objectives as set out in the second bullet point above: to support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers.

One interaction between these objectives is that more supply will support affordable housing for all New Zealanders, including first-home buyers, in the long-term. This interaction is considered in this Statement.

Section 3: Option identification

3.1 What options are available to address the problem?

The status quo is to retain current tax settings for residential housing, including applying the bright-line test to properties sold within 5 years.

The Government has identified three policy options, each with three sub-options, to be considered:

- **Option 1: Extending the bright-line period to 20 years for property acquired on or after the application date:** This option would extend the period in which properties sold could be subject to the bright-line test from 5 years to 20 years. The test would still not apply to a person's main home. There are also further options relating to new builds¹³:
 - **Option 1A:** no exemption for new-builds:
 - **Option 1B:** applying a 5-year bright-line test to new-builds:
 - **Option 1C:** completely exempting new-builds from the bright-line test:
- **Option 2: Extending the bright-line period to 15 years for property acquired on or after the application date:** This option would extend the period in which properties sold could be subject to the bright-line test from 5 years to 15 years. The test would still not apply to a person's main home. There are also further options relating to new builds:
 - **Option 2A:** no exemption for new-builds:
 - **Option 2B:** applying a 5-year bright-line test to new-builds:
 - **Option 2C:** completely exempting new-builds from the bright-line test:
- **Option 3: Extending the bright-line period to 10 years for property acquired on or after the application date:** This option would extend the period in which properties sold could be subject to the **bright**-line test from 5 years to 10 years. The test would still not apply to a person's main home. There are also further options relating to new builds:
 - **Option 3A:** no exemption for new-builds:
 - **Option 3B:** applying a 5-year bright-line test to new-builds:
 - **Option 3C:** completely exempting new-builds from the bright-line test:

There are further decisions to be made about application dates. These do not make a material difference to the analysis as the difference in dates is only a matter of days. There are further technical options to amend the bright-line test (such as the scope of exclusions) that are not assessed in this Regulatory Impact Statement.

¹³ A new-build exemption would apply to early investors in newly-built housing (any purchaser up to 12 months after the council code compliance certificate is issued under the Building Act 2004) from the extension.

3.2 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

The likely impacts of the proposals have been assessed against a set of criteria to evaluate the impact of the proposals on the Government's demand-side objectives (above at 2.5), the effect on rental affordability, and traditional tax policy criteria of efficiency, integrity, equity, revenue, compliance and administration costs, and coherence, as below:¹⁴

- **Efficiency and growth:** Taxes should be, to the extent possible, efficient and minimise as far as possible impediments to economic growth. That is, the tax system should avoid unnecessarily distorting the use of resources (e.g. causing biases toward one form of investment versus another) and imposing heavy costs on individuals and firms.
- **Equity and fairness:** The tax system should promote fairness. The burden of taxes differs across individuals and businesses depending on which bases and rates are adopted. Assessment of both vertical equity (the relative position of those on different income levels or in different circumstances) and horizontal equity (the consistent treatment of those at similar income levels, or similar circumstances) is important.
- **Revenue integrity:** The tax system should be sustainable over time, and minimise opportunities for tax avoidance and arbitrage.
- **Fiscal impact:** Tax reforms need to be affordable given fiscal constraints, and the tax system must raise sufficient revenue to support the Government's fiscal strategy.
- **Compliance and administration cost:** The tax system should be as simple and low cost as possible for taxpayers to comply with and for the Inland Revenue Department to administer.
- **Coherence:** Individual reform options should make sense in the context of the entire tax system. While a particular measure may seem sensible when viewed in isolation, implementing the proposal may not be desirable given the tax system as a whole.

The trade-offs between the different criteria are discussed in detail below.

3.3 What other options have been ruled out of scope, or not considered, and why?

The analysis is limited by the tax options already ruled out by the Government, including a comprehensive capital gains tax, a tax on a deemed rate of return for residential property, a wealth tax, or any new measure outside of the current tax framework.

The Government has set out that it intends to bring forward a broader range of supply-side measures.

¹⁴ Victoria University Tax Working Group, 2010, p. 15.

Section 4: Impact Analysis

Marginal impact: How does each of the options identified in section 3.1 compare with taking no action under each of the criteria set out in section 3.2?

	No action	Option 1A 20 year BL and no new build exemption	Option 1B 20 year BL and 5yr BL for new builds	Option 1C 20 year BL and full new build exemption	Option 2A 15 year BL and no new build exemption	Option 2B 15 year BL and 5yr BL for new builds	Option 2C 15 year BL and full new build exemption	Option 3A 10 year BL and no new build exemption	Option 3B 10 year BL and 5yr BL for new builds	Option 3C 10 year BL and full new build exemption
Support greater housing affordability for first home buyers	0	0 / +	0 / +	0	0 / +	0 / +	0	0 / +	0 / +	0
Dampening investor demand for existing housing stock	0	+	+	+	+	+	+	0 / +	+	+
Improve affordability in the rental market	0	-	- / 0	0	-	- / 0	0	-	- / 0	0
Efficiency and growth	0	+	0 / +	-	0	0	-	-	-	-
Equity and fairness (horizontal and vertical)	0	+	0 / +	-	+	0 / +	-	+	0 / +	-
Integrity	0	+	0 / +	-	+	0 / +	-	+	0 / +	-
Revenue impact	0	+	0 / +	*	+	0 / +	*	+	0 / +	*
Compliance and administration costs	0	-	--	0	-	--	0	-	--	0
Coherence	0	+	0 / +	-	+	0 / +	-	+	0 / +	-
Overall conclusion	0	+	0	-	0 / +	0	-	0	0	-

Key:

++ much better than doing nothing/the status quo
 + better than doing nothing/the status quo
 0 about the same as doing nothing/the status quo

- worse than doing nothing/the status quo
 -- much worse than doing nothing/the status quo
 * Overall impacts depend on further analysis and more detailed design

Option 1A: Extending the bright-line period to 20 years for property acquired on or after the application date (no new-build exemption)

Support greater housing affordability by putting downward pressure on house prices

Extending the bright-line period to 20 years would increase the tax cost of investment property compared with the status quo. All else being equal, this would put downward pressure on demand and therefore on property prices. This would benefit first home buyers, especially current renters with higher incomes. Due to the lack of robust empirical evidence or models, this impact cannot be quantified.

House prices continued to rise at the same time as the bright-line test was introduced in 2015 and extended in 2018, however it is not possible to determine whether they would have increased more in the absence of those policy changes or the extent of the impact that the bright-line test may have had. It is difficult to predict the impact of a much lengthier extension.

Existing property owners could be negatively impacted if the policy results in house prices being lower than they would have been otherwise. Due to the lack of empirical data, this impact cannot be quantified.

The price impact could be moderated in the long run as there could be a reduced incentive to build new houses. The impacts on long-run supply from this measure may be small as the supply of new houses is currently limited by regulatory, infrastructure and sector capacity constraints, and there is excess demand for new houses. Given the complexity and dysfunction in the housing market, the impact of demand-side tax measures on the long-run supply of new houses is complex and uncertain.

Dampening investment demand for existing housing stock

Extending the bright-line test to 20 years would increase the expected tax paid by property investors, compared with the status quo, and therefore would discourage residential property investment (including for new builds). However, the impact on residential property investors' is strongly dependent on the behavioural responses and on the availability of higher-yielding alternative investment options. It may also encourage potential investors to increase their investment in their main home, the gains from which will remain tax-free.

Improve affordability in the rental market

There is potential for an extension to the bright-line test to reduce investor demand for new rental supply, compared with the status quo. Even if there were no long-run reduction in new builds, the bright-line extension may potentially put upward pressure on rents as some of the increase in tax may be passed onto renters either directly (through higher rents) or through a reduction in rental supply as fewer properties are purchased by investor landlords in the future.

Alternatively, to the extent that rents are set by income levels, they may not significantly increase as a result of this policy. However, as noted above, this depends on behavioural responses and features of the rental market.

If this policy were to result in increased rents and reduced rental supply, it could impact on living standards if tenants spend a large proportion of their income on housing. Specifically, rent to income ratios may increase, or tenants could be forced to live in premises that are not suitable for the occupants or the number of occupants, and in extreme cases, could cause homelessness. Higher rents would decrease financial, social, and human capital stocks for renters. In this context, financial capital refers to the accumulation of assets by the person. Social capital refers to the social connections that contribute to societal wellbeing by

promoting coordination and collaboration between people and groups in society. The more secure a person's housing is, the more likely they are to make those connections. Human capital includes health, which could be negatively affected by additional crowding.

To the extent that proposals place upward pressure on rents, this appears more likely to disproportionately impact low-income households, younger people, Māori, and Pacific peoples, who are less likely to own their home relative to the general population. In addition, as around 43% of children are living in rental accommodation, upward pressure on rents could have negative impacts on child wellbeing and child poverty. Increases in rents may also lead to an increase in spending on the accommodation supplement and temporary additional support although it is difficult to quantify this impact at this stage.

Efficiency

Taxing more economic income

Taxing more capital gains through extending the bright-line period could have efficiency benefits by ensuring that more economic income is taxed. In other words, it would bring the taxation of investment in residential properties more in line with the taxation of other investment income that does not earn capital gains, such as interest income. This could improve allocative efficiency to the extent there is more consistent taxation between residential property and some other investment classes. This means investors will be making choices on the basis of actual differences in returns between assets, rather than one generated by tax advantages.

However, in line with the status quo, it would not apply to many other gains, including those on listed shares, agricultural land, commercial or industrial property, or to the sale of businesses. Because it would apply to gains on only one category of property (albeit a very high value category), it would have smaller potential efficiency gains than a comprehensive capital gains tax.

Lock-in impacts of extending the bright-line period

Extending the bright-line test would extend the 'lock-in' effect for properties held for a longer period, compared with the status quo. However, there could be competing effects on lock-in from extending the bright-line test, provided the extension is for a sufficiently long period (discussed below).

The lock-in is the incentive for residential property investors to hold property for longer to avoid the tax liability. This potentially has economic costs, as it may discourage people selling property to others who may put it to more productive use, such as housing intensification or a higher utilisation rate. It may also impact the allocation of investment as individuals may retain rental properties even when they wished to change investments, such as starting a new business.

Lock-in, a discouragement to sell, already arises with the current 5-year bright-line test ("the status quo"). In determining the impact of extending the bright-line period, data on the holding period for residential property has been considered:

Table 1. Holding period for residential property sold in 2017

Holding period	2 years or less	5 years or less	10 years or less	15 years or less	20 years or less
Percentage of property sold	18%	42%	64%	83%	91%

Source: Corelogic data prepared for the Tax Working Group

Note: This data includes residential property sold by owner-occupiers as well as investors. The data excludes property which Corelogic could not determine a holding period for (which may be a result of it being held for a very long period of time which could mean the results understate the average holding period). This data is for properties classified as either residential or lifestyle.

This data should be seen as indicative only as it includes both owner-occupied and rental properties and excludes some sales. The median holding period for residential property is approximately 7-8 years. Around 40% of properties sold were held for 5 or fewer years and around 90% of properties sold were held for 20 or fewer years.

While in principle a bright-line test of any length will have lock-in effects that will result in some economic distortions, there will be a point at which the timeframe is so long (e.g. a period of 999 years) that it will be effectively indefinite. At this point the lock-in effects will be lower than a shorter bright-line period, as the cost of waiting out the test will be too high for most owners. As a result, extending the bright-line period sufficiently can reduce the overall lock-in effect.

There are, however, competing effects from a moderately longer test and it is not possible to determine the length at which lock-in will be minimised.

On the one hand, the lock-in effects become much more potent if capital gains are a large fraction of the value of an asset. As a result, an extension of the bright-line test to 20 years would make it much more common for assets to have generated substantial taxable capital gains and be subject to high levels of tax when they were sold. A longer bright-line period, like 20 years, will have a much stronger lock-in effect than the current 5-year test, for the subset of properties that are held for a lengthy period.

However, a longer test may encourage more investors who wish to hold for shorter periods to sell within the bright-line period as compared to a shorter test. For example, compared to the status quo, a longer test may encourage more sales within 5 years, when investors would have otherwise waited out the 5-year period. This is because they would have to wait a very long time in order to not pay the tax under a longer test. The bright-line period would need to be relatively long (e.g. 20 years) to provide sufficient discouragement to ‘waiting out the period’ for individuals whose preference is to sell in a short period of time.

As noted previously, there is not good empirical evidence on which to assess these impacts. The data does suggest, however, that a significant number of houses are sold before 10 years, so reducing lock-in for these sales may well have a benefit.

In any event, it is likely that the lock-in impact will not significantly affect the utilisation rate of existing housing stock. This is because, in many cases, the property would continue to be put to the same or similar use by a different owner, meaning that a delay in sale would not result in a less productive use of the asset. For example, where a rental property is sold, it is likely to be sold for continued use as accommodation for renters or owner-occupiers.

In some cases, lock-in may prevent sales to developers who may have intensified the use of the land when existing investors would not. However, while lock-in may delay intensification, this would not be a long term impact as lock-in only delays the sale.

A concern is whether lock-in would make it relatively unattractive for taxpayers to sell little-used second homes for lengthy periods of time and whether this would significantly detract from the supply of main homes. This will depend on the extent to which such homes (e.g. holiday homes) are in areas sufficiently close to major working centres for them to be acquired by owner-occupiers or by landlords for rental housing. There is limited data to determine this impact. However, it is considered that not all second homes, such as baches, could be converted to primary residences due to their location, and hence a delay in selling these houses would not have much impact on the supply of primary residences in economic centres. In addition, little-used second homes are likely to form only a relatively small part of the overall housing stock.

Accordingly, on balance, we do not expect the lock-in effect to have a significant impact on housing utilisation compared with the status quo. While lock-in may delay investors exiting investments to undertake higher value investments, a prospective rule would only apply to new investments. Therefore, investors will factor in these considerations (long term expected return and holding period) when they enter the investment.

Revenue integrity

Extending the bright-line test will enhance the integrity of the tax system to the extent it minimises opportunities for tax avoidance and arbitrage.

This is because the extended bright-line period would cover the majority of property transactions involving non-owner-occupied residential properties, and thus reduce the ability to rely on the exclusions from the existing complex suite of land tax rules. There are existing integrity rules that apply to the current 5 year bright-line test that will carry over to the extension (for example, to deal with land-rich companies). It will be important to buttress the extended test with appropriate administrative action (see below).

As discussed, an extended test may increase the incentive to avoid the bright-line test for properties held for long periods through delaying sales as the gains are potentially large (lock-in).

Equity

Extending the bright-line period would extend the taxation of gains from a particular type of property – non owner-occupied residential property. This would enhance horizontal equity in relation to income from salary and wages, which is fully taxed. In contrast, capital gains derived from the sales of businesses or some other assets would continue to not be taxed (as under the status quo).

Some of those with second homes or rental property who sell within the bright-line period could be taxed on much of their gain at 39%, even if their normal levels of income are much lower than \$180,000.¹⁵ This is because gains that have accrued over many years would be taxed in a single year. This could be seen as unfair when many other types of gains including gains on listed shares, on agricultural land, on commercial or industrial property or on the sales of businesses would continue not to be taxed. However, payment of tax on the gain will be delayed until sale of the property, giving taxpayers a benefit in that tax is delayed compared to when income was earned.

Increasing the tax rate on capital would likely be progressive (since capital income from selling residential investment properties tends to be earned disproportionately by those on higher incomes), so would improve vertical equity.¹⁶

¹⁵ The tax paid on the sale of property may be delayed or reduced if they are held in trusts or companies.

¹⁶ See Net Worth of residential (rental) real estate, *Household expenditure statistics 2018*, Statistics NZ.

Fiscal impact

Extending the bright-line test will raise revenue. Inland Revenue has a static model to predict possible revenue arising from a 20 year bright-line extension. However, the precise sum of revenue raised will depend on investors' behavioural responses that we are unable to model.

Behavioural responses might include restructuring house ownership to lower marginal tax rates or increased rates of sales by investors who have determined they cannot wait 20 years. These effects will impact our estimates but cannot be modelled with any level of confidence.

The static model predicts that there will be no new revenue over the forecast period, as any sales in this period would be captured by the existing 5 year bright-line test. The static model suggests that an extended 20 year bright-line will start generating revenue in 2029. On the assumption of no behavioural changes, the sums generated should increase over time and could reach around 0.2% of GDP in annual revenue in 2035, depending on the behavioural responses of investors.

There are many assumptions underlying this estimate, including assumptions on the distribution of ownership, the average gain on sale and how this might change over time, the volume of sales, the probability an exemption is claimed, and the share of sales already taxable under other provisions. These assumptions have a direct impact on the estimated fiscal gain. More importantly, we expect the lock-in effect to dampen any potential fiscal gains, particularly in the longer term.

Compliance and administration costs

The bright-line extension could impose some compliance costs on relatively unsophisticated taxpayers. For example, taxpayers (including those with second homes) will often make some capital improvements to a property over a 20-year period. It can be complicated to distinguish capital improvements from repairs and maintenance. Taxpayers will be required to keep records of capital improvements for 20 years because money spent on capital improvements can only be deducted from a gain on sale.¹⁷ This may mean that taxpayers would have to keep records of improvement costs for 20 years, even if the property is ultimately held for more than 20 years.¹⁸

To implement the extension to the bright-line period, there will be administration costs to Inland Revenue and LINZ to the extent updates are required to the relevant forms, systems and guidance.

Coherence

Extending the bright-line broadens the tax base by taxing more economic income. To that extent, it enhances the coherence of the tax system compared to the status quo. However, it would result in a variety of rules taxing capital gains, which would be less coherent than a comprehensive capital gains tax.

Overall conclusion

On balance, the Treasury recommends this option. The extension will help meet some of the Government's housing market objectives. Extending the bright-line test should put downward pressure on house prices in the short to medium term, and provide equity and efficiency benefits as more economic income is taxed. Conversely, extending the bright-line test may put upward pressure on rents and have potential lock-in effects (although the additional costs

¹⁷ Repairs and maintenance expenses can be deducted against rental income.

¹⁸ Officials intend to review what costs are deductible under the bright-line test.

of these are unclear, and the Treasury's view is that lock-in will not significantly reduce housing utilisation).

Option 1B: Extending the bright-line period to 20 years for property acquired on or after the application date – excluding new builds (applying a 5-year bright-line to new-builds)

Extending the bright-line test would put downward pressure on property prices, but in doing so may reduce incentives to build new houses. A reduction in supply, compared to without the tax, would mitigate somewhat any reduction in house prices arising from the tax over the longer term. Data from CoreLogic shows that almost 40% of new build properties were purchased by multiple-property owners (a proxy for investors) in 2020. One option to mitigate the reduced incentive to build is to exclude new housing from the bright-line extension. This would mean that the 5-year bright-line period would still apply to new builds.

This option will have the same costs and benefits as Option 1A, but on a smaller scale and with additional further compliance and administrative costs. The analysis below focuses on the differences in the impacts of these options.

Support greater housing affordability by putting downward pressure on house prices

Compared to applying the extended bright-line test to all properties, special rules for new builds would lead investors to demand more new build properties (as opposed to existing dwellings), as they attract a significant tax advantage. That, in turn, means that the price of new builds is likely to be higher than without the exemption, which will mean that buyers who do not have a tax advantage (e.g. owner-occupiers) will tend to shift their demand to existing stock (particularly if they are priced out of market for new builds). There could be an impact on supply to the extent that it increases greenfield development or intensification. Over the long term any increased supply will put down pressure on prices. The overall impact of those offsetting shifts in the long run are unclear, and depend on the exemption's design, but intuition suggests that any impact of the tax changes on house prices, supply, or rents will be smaller than without an exemption.

Dampening investment demand for existing housing stock

A new build exemption could potentially reduce investment in existing property, as compared to either the status quo or having no exemption from the tax proposals, as new build properties would be at a tax advantage. Investor demand for new builds would not be expected to be reduced compared to the status quo.

Improve affordability in the rental market

Costs for investors in new builds would be lower with an exemption, and supply may be higher than without an exemption. This could suggest any potential increase in rents for new builds would be lower than for existing dwellings, but equilibrium prices for the whole rental market would likely prevail. As a result, there may be upward pressure on rents as compared to the status quo, but lower than without an exemption. The scale of this is uncertain and depends on the behavioural responses of the investors and owner-occupiers. This would mitigate some of the potential negative living standards impacts from the bright-line extension.

Efficiency

Excluding new builds would reduce the efficiency benefits of Option 1A, as capital gains on new builds purchased by early investors would remain relatively lightly taxed and out of line with other investment income. The Treasury considers there are likely to be more efficient ways to directly support supply, for example through an explicit subsidy for developers.

Equity

The impacts of the exemption reduce the equity impacts of the extension of the bright-line. Specifically, extending the bright-line test improves horizontal equity because more economic income is taxed; exempting some of this income means less is taxed which has a lower impact on horizontal equity. There is a similar effect for vertical equity considerations.

Integrity

Providing an exemption for new builds would likely be difficult to apply in practice and could open opportunities for tax avoidance.

Compliance costs and administration costs

A new build exemption would create complexity and compliance costs for taxpayers, and administrative costs for Inland Revenue

Revenue impact

Providing an exemption for new builds would reduce the revenue that the Government would otherwise receive under the bright-line extension. It has not been possible in the tight timeframe to estimate the quantum of the revenue impact of the exemption.

Coherence

The new build exemption would reduce the coherence of the tax system by creating a distortion in the types of economic income that is taxed. The exemption would not be based on established tax principles.

Overall conclusion

The Treasury does not support a new build exemption. The Treasury considers there are likely to be better ways to directly support supply, for example through an explicit subsidy for developers. In addition to the challenges set out above, the Treasury considers it would be very difficult to amend or remove an exemption in the future if further analysis concluded that alternative measures achieved a similar outcome at lower cost.

Option 1C: Extending the bright-line period to 20 years for property acquired on or after the application date – completely excluding new builds from the bright-line test

This option will have similar costs and benefits as Option 1A for existing dwellings. However, completely excluding new builds from the bright-line test will reduce the taxation of such properties compared with the status quo (as such properties are currently subject to the 5 year bright-line test). The analysis below focuses on the differences in the impacts of these options for newly-built houses.

Support greater housing affordability by putting downward pressure on house prices

Excluding new builds from the bright-line test altogether may encourage investment in newly-built residential property relative to other higher taxed investments e.g. bank deposits. It is also likely to encourage property investors to purchase new builds instead of existing housing. The effect of this is multidirectional. Greater demand for new builds could increase housing supply over the longer term. To the extent this eventuates, this could put downward pressure on house prices in the long-run. However, exempting new builds from the bright-line test decreases the tax cost of this type of investment property compared to the status quo. This could put upward pressure on demand for new builds and increase the amount investors are willing to pay, and therefore the price of new builds.

The net impact of these effects is unclear. There is a risk this could negatively impact first home buyers wishing to purchase new build properties and shift owner-occupier demand into the existing stock (which may be lower quality). Due to the lack of robust empirical evidence or models, these impacts cannot be quantified.

Dampening investment demand for existing housing stock

As noted above, exempting new builds from the bright-line test altogether is likely to encourage investors to purchase new residential properties instead of existing residential properties. This is likely to reduce investor demand for existing stock. However, the quantum would depend on property investors' behavioural responses and broader supply constraints.

Improve affordability in the rental market

Exempting new builds could increase investor demand for new rental supply, compared with the status quo. In the short-term, an exemption could potentially put downward pressure on rents to the extent that the decrease in tax is passed onto renters. However, as noted above, this depends on behavioural responses and features of the rental market. Alternatively, to the extent that rents are set by income levels, they may not decrease as a result of this policy.

Over the long-term, an exemption could put downward pressure on rents, to the extent it encourages an increase in long-run supply through greenfield developments and intensification.

If this policy were to result in decreased rents and increased rental supply, it would improve living standards. Lower rents would increase financial, social, and human capital stocks for renters. This is likely to specifically benefit low-income households, younger people, Māori, and Pacific peoples, who are less likely to own their home relative to the general population. In addition, any reduction in rents and increase in rental supply is likely to benefit child wellbeing and reduce child poverty.

Efficiency

Taxing more economic income

Exempting new builds from a bright-line test would reduce the efficiency of the tax system by reducing economic income that is taxed, relative to the status quo. It would also negatively impact allocative efficiency by increasing the tax bias towards investing in newly-built residential property as opposed to existing housing or other investments, such as bonds.

Lock-in impacts

Exempting new builds from any bright-line test would fully mitigate the lock-in effects for new build property compared with the status quo.

Equity and fairness

Exempting new builds from the bright-line test would reduce the taxation of gains from newly-built residential properties. This would reduce horizontal equity in relation to income from salary and wages, which is fully taxed. Decreasing the tax rate on capital would likely be regressive (since capital income from selling residential investment properties tends to be earned disproportionately by those on higher incomes)¹⁹, so would decrease vertical equity.

¹⁹ See Net Worth of residential (rental) real estate, *Household expenditure statistics 2018*, Statistics NZ.

Revenue integrity

Creating an exemption for new builds would reduce the integrity of the tax system. It could create incentives and opportunities to avoid taxation on the capital gains from residential property investment. It could mean a greater reliance on the other land sale rules in the Income Tax Act that have been difficult to apply in practice, such as the intention test. Even with improvements in information and reporting requirements since the introduction of the original bright-line test, there would still be practical difficulties in relying on a subjective rule like the intention test for a large group of taxpayers.

Fiscal impact

Exempting new builds from the bright-line test altogether would result in forgone revenue within the forecast period and out-years. However, officials have not had sufficient time to quantify this foregone revenue.

Compliance and administration costs

The proposed exemption would reduce the compliance costs for new-build residential investors who would no longer need to file a tax return or keep records to establish deductions under the bright-line test.

However, it would create some compliance costs for investors as they would have to prove the relevant property satisfied the requirements to be a new build. Exempting new builds from the bright-line test is likely to put more pressure on the other land sale rules in the Income Tax Act. This is likely to increase the administration costs for Inland Revenue (e.g. utilising the intention test is more resource intensive than applying the bright-line test). As the intention test is subjective in nature, there would be practical concerns with actively relying on such a rule for a large group of taxpayers. Where an investigation is opened to determine whether the intention test applies, this would also create compliance costs for taxpayers.

Coherence

Excluding new builds from the bright-line test would reduce the coherence of the tax system by excluding economic income from the tax base. Further, it would create an additional distinction not based on taxation principles.

Overall conclusion

On balance, the Treasury does not support excluding new builds from the bright-line test altogether. The exemption would reduce the effectiveness of the extension in achieving the Government's objective of supporting first home buyers by reducing any downward pressure on property prices and having a lesser impact on investor demand. However, it could reduce the extent of any upward pressure on rents. It could reduce the efficiency of the tax system by reducing economic income that is taxed. It could reduce the fairness and integrity of the tax system, and would have a fiscal cost. If the Government wishes to pursue an exemption, the Treasury prefers that exempt properties be subject to the 5 year test.

Option 2A: Extending the bright-line period to 15 years for property acquired on or after the application date (no new-build exemption)

Support greater housing affordability by putting downward pressure on house prices

Extending the bright-line period to 15 years would likely increase the tax imposed on many investment properties compared with the status quo. It would increase the tax imposed less than a 20-year period, but more than a 10-year period. Available data suggests that around

80% of properties are currently sold within a 15 year holding period at present.²⁰ This proportion may reduce if the bright-line period were extended to 15 years, as more investors are likely to hold beyond 15 years to avoid the tax liability.

While a 15 year bright-line period would put downward pressure on demand and therefore on property price inflation, it is likely to have less of an impact than a 20-year period. The benefit to first home buyers, therefore, could be less than a 20-year period. Due to the lack of robust empirical evidence or models, the difference in impacts cannot be quantified.

The increased tax could have less of a long-run impact on supply than an extension to 20-years. However, as noted above, given the complexity and dysfunction in the housing market, the impact of demand-side tax measures on the long-run supply of new houses is complex and uncertain.

Dampening investment demand for existing housing stock

Similar to Option 1A, extending the bright-line period to 15 years would likely reduce investor demand for investment property (including new builds) but to a lesser extent.

Improve affordability in the rental market

Extending the bright-line period to 15 years has the potential to reduce investor demand for new rental supply, compared with the status quo. However, it is likely to have less of an impact than for a longer bright-line test. The increased tax liability may be partially passed onto renters, however this will be less than for a longer test. This suggests that an extension to 15 year may put upward pressure on rents, which would negatively impact on renter's living standards, but this is likely to be less than with a 20-year bright-line period.

Efficiency

Taxing more economic income

Extending the bright-line period to 15 years would increase the amount of economic income that is taxed compared to the status quo. This would improve allocative efficiency, but not as much as a 20-year period.

Lock-in impacts of extending bright-line period to 15 years

Extending the bright-line period to 15 years would increase the lock-in effect for properties held for a longer period than the status quo. As noted above, there are competing effects on lock-in from different bright-line periods.

A 15-year period may be sufficiently long to discourage many investors from holding onto property to wait out the holding period. However, the accumulated capital gains might become a large fraction of the value of asset over a 15-year period, encouraging investors to hold onto the property. There is not good data to help with determining the relative impacts of the different effects described above.

In any event, as noted above, it is likely that the lock-in will not reduce housing supply through low utilisation of the existing housing stock. This is because, in many cases, the property would continue to be put to the same or similar use by a different owner, meaning that a delay in sale would not result in a less productive use of the asset.

²⁰ Subject to the limitations discussed in relation to table 1.

Equity

Extending the bright-line period to 15 years would extend the taxation of gains from non-owner-occupied residential property, compared with the status quo. This would enhance horizontal equity in relation to income from salary and wages, which is fully taxed. It would not enhance horizontal equity as much as a 20-year bright-line period.

As discussed above, increasing the effective tax rate on capital would likely be progressive (since capital income from selling residential investment properties tends to be earned disproportionately by those on higher incomes),²¹ so would improve vertical equity compared with the status quo. However, it would not improve vertical equity as much as a 20-year bright-line period.

Revenue integrity

Extending the bright-line test to 15 years would enhance the integrity of the tax system to the extent it minimised opportunities for tax avoidance and arbitrage. A 15-year period would increase the proportion of residential property transactions that are covered by the test, so it would reduce the ability of land owners to rely on the exclusions to the existing set of complex land rules.

Fiscal impact

Having a bright-line period of 15 years would raise more revenue than the status quo and a 10-year period, but less than a 20-year bright-line test. However, the precise revenue raised will depend on investors' behavioural responses that we are unable to model.

Compliance and administration costs

The additional compliance and administration costs are likely to be greater than the status quo and a 10-year period, and are likely to be similar to a 20-year period.

Coherence

Extending the bright-line period to 15 years would broaden the tax base by taxing more economic income, but less so than a 20-year period. To that extent, it enhances the coherence of the entire tax system compared to the status quo.

Overall conclusion

On balance, this is not the Treasury's preferred option. However, the Treasury recommends it over the status quo. The extension will help meet some of the Government's housing market objectives - but not to the same extent as a 20-year extension. Extending the bright-line test would put downward pressure on house prices in the short to medium term, and provide equity and efficiency benefits as more economic income is taxed. Conversely, extending the bright-line test may put upward pressure on rents and have potential lock-in effects (although the additional costs of these are unclear, and the Treasury's view is that lock-in will not significantly reduce housing utilisation).

Options 2B and 2C: Extending the bright-line period to 15 years for property acquired on or after the application date with exemptions for new builds

Providing either a full or partial exemption for new builds from a 15 year bright-line extension would have similar impacts to Options 1B and 1C.

²¹ See Net Worth of residential (rental) real estate, *Household expenditure statistics 2018*, Statistics NZ.

Option 3A: Extending the bright-line period to 10 years for property acquired on or after the application date (no new-build exemption)

Support greater housing affordability by putting downward pressure on house prices

Extending the bright-line period to 10 years would likely increase the tax imposed on some investment properties compared to the status quo. However, it would increase the overall tax imposed by less than a longer extension. Available data suggests that around two-thirds of properties are currently sold within 10 years, although this figure may reduce substantially under a 10 year bright-line test.

While a 10 year bright-line period would put downward pressure on demand and therefore on property price inflation, it would have less of an impact than a longer period. The benefit to first home buyers, therefore, would be less than a longer extension. Due to the lack of robust empirical evidence or models, this impact cannot be quantified.

In contrast, the lower overall tax cost could have less of a long-run impact on supply. However, as noted above, given the complexity and dysfunction in the housing market, the impact of demand-side tax measures on the long-run supply of new houses is complex and uncertain.

Dampening investment demand for existing housing stock

Extending the bright-line period to 10 years may reduce investor demand for investment property (including new builds).

Improve affordability in the rental market

Extending the bright-line period to 10 years has the potential to reduce investor demand for new rental supply, compared with the status quo. However, it is likely to have less of an impact than a longer bright-line period. The increase in tax liability will be smaller than for a longer period. This suggests that an extension to 10 years may put some upward pressure on rents, which would have negative impacts on renter's living standards, but this is likely to be less than with a longer bright-line period.

Efficiency

Taxing more economic income

Extending the bright-line period to 10 years would increase the amount of economic income that is taxed compared to the status quo, but not as much as a longer period. This would improve allocative efficiency compared with the status quo but not as much as a longer period.

Lock-in impacts of extending bright-line period to 10 years

Extending the bright-line period to 10 years would create lock-in for properties held for 5-10 years. Under the status quo (5 years), there is currently no lock-in for the properties held for more than 5 years. As noted above, there are competing effects on lock-in from different bright-line periods and it cannot be determined whether a 10, 15 or 20-year test would have the greatest lock-in.

Compared to a 20-year test, a 10-year test may not significantly reduce lock-in for properties intended to be held for short periods, as many individuals will be willing to wait out a 10-year test. Based on the data discussed above, around two thirds of properties are currently sold before 10 years and may be subject to lock-in under a 10-year test. However a 10-year test will not give rise to lock-in for properties held between 10 and 20 years, and as the tax

liability will be lower at 10 years than 20 years, the lock-in effect will be lower approaching 10 years than 20 years.

Equity

Extending the bright-line period to 10 years would extend the taxation of gains from non-owner-occupied residential property, compared with the status quo. This would enhance horizontal equity in relation to income from salary and wages, which is fully taxed. However, it would not enhance horizontal equity as much as a longer bright-line period.

Increasing the tax imposed on capital income would likely be progressive (since capital income from selling residential investment properties tends to be earned disproportionately by those on higher incomes), so would improve vertical equity compared with the status quo.²² However, it would not improve vertical equity as much as a longer bright-line period.

Revenue integrity

Extending the bright-line period to 10 years would enhance the integrity of the tax system to the extent it minimises opportunities for tax avoidance and arbitrage. It would extend the range of property transactions covered by the rule, compared with the status quo. However, more transactions would be subject to the other land rules (with their complexities and exclusions) than under a longer bright-line period.

Fiscal impact

Having a bright-line period of 10 years would raise more revenue than the status quo, but less than a longer bright-line period. However, the precise revenue raised will depend on investor's behavioural responses that we are unable to model

Compliance and administration costs

The additional compliance and administration costs are likely to be greater than the status quo, but less than a longer bright-line period.

Coherence

Extending the bright-line period to 10 years would tax more economic income than the status quo, but less than a longer period. It would enhance the coherence of the tax system but less than a longer period. Compared to a comprehensive capital gains tax, having multiple mechanisms to tax capital gains would be less coherent.

Overall conclusion

On balance, the Treasury would prefer an extension of the bright-line test for a period longer than 10 years. Extending the bright-line period to 10-years would help meet some of the Government's housing market objectives but to lesser extent than a longer period. The extension may put some downward pressure on house price inflation in the short to medium term, and provide equity and efficiency benefits as more economic income is taxed, however these benefits will be significantly less than for a 20 year period. Conversely, extending the bright-line test to 10 years may put some upward pressure on rents, but less than for a longer extension, and have potential lock-in effects (although the additional costs of these are unclear, and the Treasury's view is that lock-in will not significantly reduce housing utilisation). It may be relatively easy to avoid the tax liability under a 10 year test by delaying the sale of property.

²² See Net Worth of residential (rental) real estate, *Household expenditure statistics 2018*, Statistics NZ.

Option 3B and 3C: Extending the bright-line period to 10 years for property acquired on or after the application date with exemptions for new builds

Providing either a full or partial exemption for new builds from a ten year bright-line extension would have similar impacts to Options 1B and 1C, though to a smaller extent.

Section 5: Conclusions

5.1 What option, or combination of options is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

In light of the Government's objectives and the above constraints, on balance the Treasury's preferred option is **an extension of the bright-line period from 5 years to 20 years with no exemption for new builds**.

While tax settings are not the primary driver of problems in the housing market, extending the bright-line test should put downward pressure on house prices in the short to medium term, and provide equity and efficiency benefits in taxing more economic income. However, extending the bright-line test may put upward pressure on rents.

While the extension may result in lock-in effects, the additional costs of these are unclear. The Treasury's view is that lock-in will not significantly reduce housing utilisation.

Therefore, the Treasury considers the measure improves the tax system on balance and contributes to the Government's stated demand-side housing objectives: to support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers.

The Treasury's preferred option is a 20-year bright-line test, however it also considers a 15-year bright-line test is superior to the status quo as it would help meet some of the Government's housing market objectives - but not to the same extent as a 20-year bright-line test. In the time available, the Treasury has not formed a view on whether a 10-year bright-line test is preferable to the status quo.

The Treasury does not recommend providing an exemption from the extended or existing bright-line test for early investors in newly constructed homes. An exemption comes with additional administrative and compliance costs, and over time reduces the coherence of the tax system. While increasing housing supply is important, the Treasury considers there are likely to be better ways to directly support supply, for example through an explicit subsidy for developers. If the Government wishes to implement an exemption, the Treasury prefers exempt property to be subject to the 5 year bright-line test.

There are significant data and analytical limitations, and so there is a low rating for the evidential certainty of the relevant impacts. In addition, the analysis has been prepared under significant time constraints, further limiting the evidential certainty.

Due to time constraints, there has been no opportunity for consultation on the proposal to extend the bright-line period or the proposed exemption for new builds.

5.2 Summary table of costs and benefits of the preferred approach

Affected parties (identify)	Comment: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks	Impact \$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts	Evidence certainty (High, medium or low)
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Additional costs of proposed approach compared to taking no action

<p>Regulated parties: Residential property investors</p>	<p>Extending the bright-line test would increase the expected tax paid by property investors. This could put downward pressure on house prices.</p> <p>For the marginal investor, the proposals could be the ‘tipping point,’ so they would forgo the purchase, as other alternative investments become relatively more attractive. However, if the reduced return is still expected to be the highest yielding investment (adjusted for risk) then it is rational for them to purchase the property.</p> <p>All investors face some risk of being taxed under the extended bright-line, including those who did not acquire the residential property with an intention of resale. This could discourage investors concerned that they may face unexpected circumstances that would lead them to have to sell before 20 years has passed.</p> <p>The extended bright-line test also increases the incentive for investors to hold on to their properties for a period exceeding 20 years (the “lock-in effect”). They may delay the sale of the property beyond what may have otherwise been optimal. While these investors would not incur the costs of the tax, the timing</p>	<p>The quantum of the impact on residential property investors is strongly dependant on the behavioural responses and on the availability of higher yielding alternative investment options.</p> <p>As these factors are not known, the impact on investors is not able to be quantified.</p> <p>House prices continued to rise at the same time as the bright-line was introduced in 2015 and extended in 2018, however it is not possible to determine whether they would have increased more in the absence of those policy changes or the extent of the impact that the bright-line may have had. It is difficult to predict the impact of a much lengthier extension.</p> <p>One indicator of the possible impact on property investors is the estimated increase in tax revenue. Inland Revenue’s static</p>	<p>Low</p>
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	distortion may reduce their overall gain.	model predicts that there will be no new revenue over the forecast period, as any sales in this period would be captured by the existing 5 year bright-line test. The static model suggests that an extended 20 year bright-line will start generating revenue in 2029. On the assumption of no behavioural changes, the sums generated should increase over time and could reach around 0.2% of GDP in annual revenue 2035, depending on the behavioural responses of investors.	
Regulated parties: Owner-occupiers	To the extent that the extension of the bright-line test succeeds in reducing demand from residential property investors, this could result in house prices being lower than they would have been otherwise. This could negatively impact current owner-occupiers, and reduce their financial capital.	Due to the lack of empirical data, this impact cannot be quantified, but it is expected to be marginal (for the reasons set out above).	Low
Regulated parties: residential tenants	<p>The extension may put upward pressure on rents through decreasing rental supply. This means renters may be negatively impacted by the proposals.</p> <p>Increased rents may impact tenants' living standards as it may mean that housing costs are high compared to their incomes or they are forced to live in premises that are not suitable for the occupants or the number of occupants, and limit their level of privacy and personal space. It may also cause crowding. Overall, this would reduce their financial and social capitals.</p> <p>To the extent that proposals place upward pressure on rents, this appears more likely to</p>	<p>Due to the lack of empirical data, this impact cannot be quantified. It would depend on both the market conditions and the behaviour of market participants.</p> <p>The overall change in demand (which influences the rental price), will depend on the extent to which people alter behaviour in response to the price change. This could be in the form of a transition to home-ownership (for the higher-income renters), a move down</p>	Low

	<p>disproportionately impact low-income households, younger people, Māori, and Pacific peoples, who are less likely to own their home relative to the general population. In addition, as around 43% of children are living in rental accommodation, upward pressure on rents could have negative impacts on child wellbeing and child poverty.</p> <p>Some renters may take advantage of lower house prices to become owner-occupiers. This would give them the opportunity to increase their financial and social capitals.</p>	<p>the housing spectrum (e.g. a younger person may move back in with their parents), or an increase in household occupancy rates to spread the rental costs over more people.</p>	
Regulated parties: stakeholders with interests in macro-financial stability (including banks)	To the extent that the extension of the bright-line test succeeds in reducing demand from residential property investors, this reduction in aggregate demand for residential property at the margin may reduce price pressures, all else being equal. If there was a large price impact, this may have a negative impact at the margins for banks.	The impact for banks is unquantifiable but is unlikely to be significant. The Reserve Bank has advised current banking system buffers are strong.	Low
Regulators/regulatory agencies	To implement the extension to the bright-line period (and relevant changes), there will be administration costs to Inland Revenue and LINZ to the extent updates are required to the relevant forms, systems and guidance.		
Wider government	To the extent that the policy results in increased pressure on rents, it may also lead to an increase in spending on the accommodation supplement and temporary additional support.	Due to the lack of data, it is difficult to quantify this impact at this stage.	Low
Total Monetised Benefit	We do not have confidence in the ability to provide a total monetised cost	Low	Low
Non-monetised costs	As described above	Low	Low

Expected benefits of proposed approach compared to taking no action			
Regulated parties: first home buyers	At the margin, reduced competition from residential property investors in the market may reduce pressure on prices and make it somewhat easier for prospective first-home buyers to purchase a property. This would improve their financial capital and social capital (as indicated above).	Due to the lack of empirical data, this impact cannot be quantified. It would depend on both the market conditions and the behaviour of market participants.	Low
Wider government	Increased revenue would be collected from the sale of residential investment property, as the extension of the bright-line test would make more sales taxable.	Inland Revenue's static model predicts that there will be no new revenue over the forecast period, as any sales in this period would be captured by the existing 5 year bright-line test. The static model suggests that an extended 20 year bright-line will start generating revenue in 2029. On the assumption of no behavioural changes, the sums generated should increase over time and could reach around 0.2% of GDP in annual revenue 2035, depending on the behavioural responses of investors. This on the basis of no exemptions for new builds.	Medium
Total Monetised Benefit	We do not have confidence in the ability to provide a total monetised benefit.	Low	Low
Non-monetised benefits	As described above.	Low	Low

5.3 What other impacts is this approach likely to have?

Other impacts that may result from the extension of the bright-line test include:

1. The 'lock-in' effect – i.e. investors retain properties longer than they otherwise would have as a result of the desire to avoid the tax. While the efficiency impacts of this are partially borne by the investors (as noted above), there are wider impacts on the housing market. The impact of lock-in on the housing market is unclear. For example, it could potentially improve tenure stability for renters but reduce the flow of housing onto the market for owner-occupiers to buy. The reduced flow could arise from the reduced utilisation of the housing stock, as the extended bright-line test may discourage people selling property to others who may put it to more productive use, such as housing intensification or a higher utilisation rate.
2. If the proposals reduce demand from investors, this may (all else being equal) improve affordability for first-home buyers (as they face less competition in the market from investors) (this is the objective of the measure). This has other non-monetary flow on impacts, such as greater stability of tenure (and the associated secondary benefits), or decreased labour market mobility.
3. Impact on related markets – The consequential impacts on related markets from this policy are not clear. To the extent that this policy discourages investors and reduces investor demand, the capital that would have otherwise been invested in residential property is displaced to other markets. This 'displaced' capital may manifest in one or more of the following outcomes:
 - Marginally increased demand for alternative investment types (as residential investment becomes relatively less attractive).
 - Purchasing a relatively more expensive main home than would otherwise be the case, as people invest more capital into the (untaxed) family home instead of investment property.
 - Other (non-housing) forms of increased consumption spending (as the net returns from investment decrease, consumption becomes relatively more attractive).
 - Reduced demand for complementary goods and services, such as real estate and conveyancing services.
 - Lower savings: if alternative investments have lower yields, this will reduce savings (particularly retirement savings) of people who would have otherwise been landlords.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

The Treasury and Inland Revenue understand that Ministers intend the proposals to apply to new purchases of property only. Given this, there is a risk that if there is a delay between announcement and the time from which the proposals apply, investors will seek to purchase property before the proposals apply.

Officials recommend aligning the date of announcement with the date at which new purchases will be subject to the new regime. This means that when legislation is enacted, it will apply retrospectively.

There is likely to be an expectation that when the changes are announced, there will be a sufficient level of detail to allow people to assess whether the changes apply to them, given that the Government will be announcing its intention to pass retrospective legislation.

Bright-line announcement

Officials recommend announcing that the bright-line extension is intended to be applicable from 11.59pm on the day of the announcement.

6.2 What are the implementation risks?

There has been no consultation on these proposals to date. A consultation process on how the proposals would be implemented would mitigate any risk of overreach (including properties not intended to be affected) or under-reach (not including intended properties).

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

To assist work on compliance with property transactions, Inland Revenue now includes property-related information into its Data Intelligence Platform (DIP). The DIP brings together data from different sources to provide an end-to-end view of property transactions throughout New Zealand. While still under development, the DIP is being used to identify suspected cases of property non-compliance and is a searchable record of customers' past property transitions.

To support an extended bright-line period and exempting new-builds from the new rules, Inland Revenue would look to enhance information it collects from customers directly and/or via LINZ, however the details of this are still being worked through.

Given the many competing influences on housing affordability, officials do not expect to be able to monitor the impact of this arrangement on the housing market, house prices, or rents.

7.2 When and how will the new arrangements be reviewed?

There are measures in place to review the existing 5-year bright-line test. These measures will continue to be used for an extended bright-line test.

Policy officials maintain strong communication channels with stakeholders in the tax advisory community, and these stakeholders will be able to correspond with officials about the operation of the new rules at any time. If problems emerge, they will be dealt with either operationally, or by way of legislative amendment if agreed by Parliament.