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POLICY AND REGULATORY STEWARDSHIP

Tax policy report: Clarification of bright-line test design details

Date:	12 March 2021	Priority:	High
Security level:		Report number:	IR2021/107

Action sought

	Action sought	Deadline
Minister of Finance	Agree to recommendations	18 March 2021
Minister of Revenue	Agree to recommendations	18 March 2021

Contact for telephone discussion (if required)

Name	Position	Telephone
Peter Frawley	Policy Lead	[39] [35]
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12 March 2021

Minister of Revenue

Clarification of bright-line test design details

Purpose

1. This report seeks a decision on the method to be used for calculating taxable gains under the bright-line test when a property has been used as the owner's main home for only part of the period of ownership. Officials recommend that only straight-line apportionment should be available.
2. This report also seeks a decision on the type of offers made on or before the announcement date that should be subject to the existing five-year bright-line test rather than the extension.
3. The proposed changes to the bright-line test are due to be included in a Supplementary Order Paper (SOP) to be released on 22 March, with the draft to be provided to you at the end of next week. This SOP will be considered at the Committee of the whole House stage of the Taxation (Annual Rates for 2020—21, Feasibility Expenditure, and Remedial Matters) Bill which is planned for the sitting week beginning 23 March.

Background

4. On Monday 8 March, Cabinet considered the paper 'Backing first home buyers and encouraging property investment into new housing supply' [CAB-21-SUB-0045 refers]. Cabinet agreed to a number of recommendations, including:
 - 4.1 extending the bright-line test with the number of years to be confirmed at the next Cabinet meeting on Monday 15 March (recommendation 5),
 - 4.2 an application date of 72 hours post-announcement, except for where the property is acquired as a result of an offer made before the end of the day of announcement in which case the existing 5-year bright-line test would apply (recommendations 6 and 7),
 - 4.3 changing the main home exclusion from an all-or-nothing approach to a change-of-use rule, to ensure that tax is paid on gains made during periods the property was not used as the owner's main home (recommendation 9.2),
 - 4.4 Authorising the Minister of Finance and Minister of Revenue to make further design decisions of a technical nature on the extended bright-line test (recommendation 11) [CAB-21-MIN-0045 refers].
5. Officials consider that the design of the change-of-use rule, in particular, the calculation method(s) available, and the treatment of offers made on or before the announcement date are within scope of this delegated authority.

Change-of-use rule for main home exclusion

6. Under current law, the main home exclusion provides that gains are not taxed under the bright-line test if for most of the period of ownership, the property is predominantly used as the person's main home. This means that if a person uses a property as their main home for at least 50% of the time, gains over the whole

period of ownership are not taxed under the bright-line test. This is not a concern with a 2-year or 5-year bright-line test and provides a simple, easy-to-apply rule. However, with an extension to 20 years (for example), a house used as a rental property for 9 years and as a main home for 10 years would be fully outside the bright-line test, which would not be appropriate given that much more income could be involved.

7. It is for this reason Cabinet has agreed to a change-of-use rule for the main home exclusion. The change-of-use rule would require the apportionment of gains between periods of use as a main home and other use (such as a rental property). For example, if a property is used as a main home for seven years and as a rental property for three years before selling it, the owner would be required to account for the gain in the value of the property during the three years it was a rental property.

Calculation methods

8. Originally, officials had considered that there could be two calculation methods for the change-of-use apportionment rule, which were discussed in the body of the Cabinet paper but were not specified in the Cabinet recommendation [paragraphs 96.2 and 96.3 of CAB-21-SUB-0045 refers]:
 - 8.1 Default method: straight-line apportionment using the purchase price, sale price and amount of time the property was used as the owner's main home to determine the portion of the overall capital gain that is taxable.
 - 8.2 Optional actual gains method: the actual value of the property at the time the change of use occurs could be used to calculate the gains that should be taxed when the property is not the owner's main home.
9. In drafting the amendments to the bright-line test, legislating the second "actual gains" method has been substantially more complex than first envisaged and we are unable to draft simpler provisions for this in the time available. We therefore propose only the default method allowing for straight-line apportionment be included in the SOP to the Bill.
10. Integrity concerns about the manipulation of the actual gains method to minimise the amount of tax payable have also been identified. The example in the Cabinet paper referred to a rating valuation, but these are not updated regularly, so the figure could therefore be inaccurate, particularly in the current climate. This could lead to substantial under-taxation. While professional valuations can be obtained, we understand that these can cover an acceptable range which can vary and can be a large range. Taxpayers would be incentivised to cherry-pick the valuation that shows more of the total gain was earned while the property was their main home than when it was a rental property.

Example

Bob purchases a house for \$500,000 in January 2022. Bob uses it as his main home until January 2024 when he moves out and rents out the property. Bob continues to rent it out until January 2027. Bob moves back in and uses it as his main home until he sells the property in January 2030 for \$1 million.

Straight-line apportionment

The total gain over the period of ownership is \$500,000 (\$1m - \$500k). Bob owned the property for eight years and it was used as Bob's main home for five years. Therefore, Bob's taxable gain will be 3/8ths of \$500,000, or \$187,500.

Actual gains method

Bob obtains estimates of the property's value when the property's use changed in 2024 and 2027. In 2024, Bob obtained two valuations – one for \$600,000 and one for \$700,000. In 2027, Bob received another two valuations – one for \$725,000 and another for \$850,000.

In calculating the actual gains using the valuations he obtained, Bob could use \$700,000 as his 2024 value and \$725,000 as his 2027 value, resulting in a taxable gain of \$25,000. The other valuations (\$600,000 and \$850,000) would have resulted in a taxable gain of \$250,000.

Bob also checks his property's rateable value. When he purchased the property the rateable value was \$475,000. This was revised to \$600,000 in 2024 and was not revised again until 2028, so the rateable value in 2027 was also \$600,000. Using rateable value would therefore mean there would be no taxable gain, as there was no change in the rateable value between the start and end of the rental period.

11. Officials consider that taxpayers having the option to use the actual gains method risks the integrity of the bright-line test and are not confident that the risk can be mitigated in the short term. Other jurisdictions with a comprehensive capital gains tax have complex rules and guidelines for valuations and may have stronger regulatory frameworks surrounding the valuation profession that we have not been able to look at in the required timeframe.
12. Officials' preference would therefore be for the default straight-line method to be the only calculation method. With limited resources available, we consider that other aspects of the Government's work programme on housing and tax should take priority over work on an actual gains method – particularly the work on denying interest deductions, and the new build exemption.

Offers made before the end of the announcement date

13. Cabinet agreed that an extended bright-line test will generally apply to residential property acquired 72 hours after the announcement date [CAB-21-MIN-0045 refers]. Acquisition for most land purchases will be where there is a binding agreement between the purchaser and seller, even if there are standard conditions (for example, obtaining finance or a building report) still to be satisfied.
14. This means that a potential purchaser who submits an offer on or before the announcement date could be subject to the extended bright-line test, if the seller does not accept their offer until on or after the application date. For example, a potential buyer submits their offer on 19 March. If the extended bright-line test is announced on 22 March, the application date would be 26 March. If the seller

accepts the offer on 25 March, the buyer would be subject to the existing five-year bright-line test, but if the seller accepts the offer on 26 March, the extended bright-line period would apply to the purchaser.

15. The Cabinet paper discusses this issue at paragraph 95 [CAB-21-SUB-0045 refers]. In many situations, a prospective buyer would be able to withdraw their offer and the 72-hour window between announcement and application would enable this to occur if the prospect of an extended bright-line test impacts the prospective buyer's decision. However, in some situations, once an offer has been made by a potential buyer, it cannot be revoked for a certain period of time. For example, in tenders it is typically the case that after the tender deadline a prospective buyer is not able to revoke their offer for five working days if the seller has not made a decision. Therefore, there may be some situations where a potential buyer would like to withdraw their offer upon hearing about the extended bright-line test, but are unable to do so due to the period of irrevocability.
16. Cabinet therefore agreed to exclude residential properties acquired on or after the application date if acquired as a result of an offer made before the end of the day of announcement [CAB-21-MIN-0045 refers]. The recommendation does not refer specifically to tender offers or irrevocable offers, although this was intended to be the focus of the discussion in the body of the Cabinet paper.
17. As currently worded, the recommendation would apply to all offers made before the end of the announcement date, even if the offer was able to be revoked before the application date and the potential buyer decided to proceed with the offer.
18. Officials therefore seek Ministerial direction on the scope of Cabinet recommendation 7 [CAB-21-MIN-0045 refers] as to whether it should be read broadly as per paragraph 17 above, or whether it should be limited to offers that were not able to be revoked by the buyer before the application date. Inland Revenue's preference is that it should apply only to irrevocable offers.

Examples

These examples assume an announcement date of 22 March – which would mean an application date of 26 March.

Maia submits an offer as part of a tender process that closes on 22 March. Under the terms and conditions accepted by Maia in the tender document, she would not be able to withdraw her offer until 30 March. The seller accepts her offer on 26 March and the sale and purchase agreement is signed that day. Maia would be subject to the existing bright-line period of 5 years as she was not able to revoke her offer until after the application date.

Jo submits an offer as part of a tender process that closes on 16 March. Under the terms and conditions in the tender document, they are unable to withdraw their offer until 23 March. Jo considers withdrawing their offer on 24 March, but they decide against it. The seller accepts Jo's offer on 27 March and the agreement is signed. Jo would be subject to the extended bright-line period because they acquire the land after 26 March and they were able to revoke their offer before 26 March.

Consultation

19. Treasury and the Ministry of Housing and Urban Development were consulted in the preparation of this report.

Next steps

20. Cabinet authorised the Minister of Revenue, in consultation with the Minister of Finance and the Leader of the House, to release a Supplementary Order Paper (SOP) containing the changes to the bright-line test at the Committee of the whole House stage of the Taxation (Annual Rates for 2020—21, Feasibility Expenditure, and Remedial Matters) Bill (the Bill) [CAB-21-MIN-0045 refers].

21. The draft SOP containing the proposed changes to the bright-line test will be provided to you at the end of next week. Subject to decisions taken by Ministers in this report, this could be released on Monday 22 March, with the Committee of the whole House stage for the Bill planned for that week.

Recommended action

We recommend that you:

Main home exclusion

22. **Note** that officials have not been able to draft in the time available an actual gains method for the change-of-use rule in the main home exclusion from the bright-line test that addresses complexity and integrity concerns;

Noted

Noted

23. **Agree** that only the straight-line method for apportionment for the main home exclusion from the bright-line test be included in the SOP to the Taxation (Annual Rates for 2020—21, Feasibility Expenditure, and Remedial Matters) Bill

Agreed/Not agreed

Agreed/Not agreed

24. **Agree** that officials not do further work on an actual gains method for the main home exclusion from the bright-line test;

Agreed/Not agreed

Agreed/Not agreed

Offers made before the end of announcement date

25. **Note** that Cabinet agreed that an extended bright-line test would not apply to land acquired on or after the application date, if the acquisition occurs as a result of an offer made before the end of the day of announcement (the application date rule);

Noted

Noted

26. EITHER:

Agree that this carveout to the application date rule should apply only to an offer made by a purchaser that could not be revoked before the application date;

Agreed/Not agreed

Agreed/Not agreed

OR

Agree that this carveout to the application date rule should apply to all offers made before the end of the announcement date (even if the offer was able to be revoked).

Agreed/Not agreed

Agreed/Not agreed

Peter Frawley
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Hon Grant Robertson
Minister of Finance
/ /2021

Hon David Parker
Minister of Revenue
/ /2021