Coversheet: Extension of the bright-line test for the taxation of residential property

Advising agencies	*Inland Revenue, The Treasury*
Decision sought	*Approval to extend the current bright-line test from two years to five years.*
Proposing Ministers	*Minister of Finance, Minister of Revenue*

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 for extending the bright-line test is to ensure that residential property speculators pay tax on the gains from their activity and also to improve housing affordability for owner-occupiers by reducing speculative demand.

Proposed Approach **How will Government intervention work to bring about the desired change? How is this the best option?**
The Government has publicly indicated it will extend the current bright-line test from two years to five years and that the current exemptions (including the main home exemption) from the bright line test will continue. This extension is intended to target speculators in the residential property market.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
Taxpayers and Inland Revenue will benefit from an additional period of clarity, as the bright-line rule will apply for longer. It is difficult to quantify these benefits. We expect that the longer the period that the bright-line test applies, the easier it will be for Inland Revenue to collect revenue from property speculators. The longer bright-line test also means that it is easier for taxpayers to know whether a particular residential property sale is taxable. The change will increase the number of property sales that are subject to tax. Some of these sales will be by speculators and some will be by investors. For the purposes of this analysis, speculators are those who buy houses with the aim of resale for profit and investors are those who did not acquire a residential property with an intention of resale. The extended bright-line test is expected to raise additional revenue for the government. However, it will not raise any additional revenue in the short run, due to the existing two year bright-line test. In the third year after coming into force, revenue is expected to

increase each year until it reaches about $50 million per year.

To the extent that the longer bright-line discourages speculators and investors from buying residential property, prospective first-home buyers could benefit from this proposal. At the margin, discouraging residential property speculators may also reduce competition in the housing market, reducing upward pressure on property prices and improving housing affordability for first-home buyers.

Existing owner-occupiers who are seeking to move up the property ladder may also be positively impacted by this policy, to a lesser degree. While less competition in the market may reduce the price they would otherwise receive for their existing property, it may also reduce the price of the next property they buy.

Where do the costs fall?

The costs of the additional tax raised by the extended bright-line test fall on residential property speculators and investors who, by virtue of the timing of their property sales, are taxed on any gains made on the property sale.

In the case of investors, the longer bright-line test is more likely to capture sales where the property was not acquired with an intention of resale.

Both speculators and investors who delay the sale of the property, beyond what would have otherwise been the optimal time to sell (in order to avoid the tax), also bear an indirect cost. This delay is sometimes referred to as lock-in and it imposes economy wide costs because it reduces the efficient allocation of resources within the economy.

While the precise nature and magnitude of the policy across the impacted parties are not known, due to the lack of empirical evidence and uncertainty of the behavioural response and future market conditions, this policy may impose costs (either indirectly or directly) on residential property: speculators; investors; tenants; and parties in related markets who experience demand fluctuations for their goods or services that correlate with housing market activity, such as conveyancers.

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

There are two key risks with extending the bright-line test from two years to five years. The first is over-reach and the second is lock-in. There are also potential impacts on tenants.

Over-reach

The longer bright-line test means that there is more risk of capturing sales of residential property that was not acquired with an intention of resale.

The original policy intent for the two-year bright-line test was to capture short-term speculative activity in the residential property market. The two-year period was set on the basis that buying and selling within a short window of time is likely to be indicative that the property was bought with the intent to make a profit on resale. When extended to five years, however, there is a risk that this association becomes less clear.

This risk could be managed by providing more exemptions to the bright-line test. The current two year test has the following exemptions, the sale of the main home, relationship property settlements, and distributions by estates. With the longer bright-line test there are stronger grounds to provide exemptions to cover other situations that arise – for example illness or restructuring. However, the trade-off is that the bright-line test becomes less clear when exemptions are added. We also note that adding more exemptions would increase the complexity of the rules, making the bright-line test more difficult for taxpayers to comply with and for Inland Revenue to enforce. The bright-line test is intended to be an objective rule that is easy to apply.

Lock-in

The other risk with the extended bright-line test is the heightened risk of 'lock-in', which impacts on the efficient allocation of residential property. The costs that flow from lock-in are difficult to quantify. However, these costs are non-trivial because they get in the way of the efficient allocation of resources within an economy. Lock-in also discourages individuals and entities from reorganising how they hold assets.

While lock-in does not alter the actual number of dwellings in the overall housing stock, it may reduce the number of dwellings for sale. If the fall in the number of dwellings for sale exceeds the reduced demand from speculators and investors then this could lead to increased competition for the housing stock available for purchase for a period of time. Because of the competing impact of these variables, the impact of lock-in on the housing market is ambiguous.

Tenants

Any reduction in the supply of residential rental properties, due to the reduction in speculators and investors buying and renting out property, is likely to put upward pressure on rents. A higher level of homeownership among former renters is unlikely to completely offset the pressure on rental prices. This is because owner-occupied homes typically have a lower occupancy rate than rental homes, so the reduction in the supply of rental housing (caused by some investors exiting the market) will probably outweigh the reduction in demand for rentals (as some renters purchase homes).

Overall implications

The Treasury notes that the risks relating to over-reach and lock-in are unable to be quantified and therefore it is difficult to assess their significance in relation to the Government's objectives for extending the bright-line test. The IRD considers that two years is the better bright-line period, mainly because this reduces over-reach.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
The Treasury
Quality Assurance Assessment:
No formal assessment being given since this is a 100 Day Plan priority.
Reviewer Comments and Recommendations:
The Treasury's comments are based on revised expectations for Regulatory Impact Assessments covering 100 Day Plan priorities. The Regulatory Impact Assessment describes how the proposed action will meet the intended objectives and also explains the uncertainties and risks around its likely impact on the broader housing market. The impact on different parties including speculators, investors, tenants and parties in related markets who experience demand fluctuations for their goods or services that correlate with housing market activity, such as conveyancers, are well explained. The analysis of the overall impact on housing markets is more limited, due to limited empirical evidence and the uncertainty around the behavioural response and future markets conditions, recognising that there may be possible unintended consequences. In addition, as noted in Section 1 of the Regulatory Impact Statement - "Key Limitations or Constraints on Analysis" - only the proposed option has been assessed. Consequently, it is not possible to be confident that the Government's objectives are being met in the best way and with the least unintended consequences. It would therefore be desirable to monitor and evaluate the outcomes in practice. It is noted that IRD will continue to evaluate its programmes in terms of taxpayer compliance with the current law, including the bright-line test and that officials will monitor the general housing market indicators collected by the Ministry of Business, Innovation and Employment (MBIE). We would recommend that further thought be given to possible ways of observing the specific impact of this policy on market outcomes, as this could be of value in future policy decision making.

Impact Statement: Extension of the bright-line test for the taxation of residential property

Section 1: General information

Purpose
The original bright-line test, when it was first introduced in 2015, provides an unambiguous rule for taxing gains made when residential property is sold. This rule supplements the current land sale rules. The bright-line test was targeted towards the problems of enforcement in relation to the significant churn and short term speculation in residential property that had been occurring in the period leading up to Budget 2015. Many taxpayers did not appear to be self-assessing their sales as taxable, while the subjective nature of the 'intention test' made it difficult to enforce. The bright-line test was intended to overcome the enforcement challenges arising from the subjective 'intentions' measure by establishing an unambiguous position based on the timing of the sale of the property. The main objective for extending the bright-line test (from two years to five years) is to capture more speculators trading residential property and to ensure that those who make gains from speculative property investment pay their fair share of tax. Another objective for extending the bright-line test is that – by reducing speculative demand – this improves housing affordability for owner-occupiers. In 2015, Inland Revenue and the Treasury supported the two year bright-line test to improve the integrity of the land sale rules. In 2010, the Treasury provided advice on a bright-line test for residential property, with a minimum of a five year period, as a base-broadening option for Budget 2010.

Key Limitations or Constraints on Analysis
The key limitations and constraints applying to this analysis are as follows: 1. <u>Single option analysis:</u> As the Government has already announced its intention to extend the bright-line test, this analysis is focussed solely on the implementation of that option. 2. <u>Time constraints:</u> Ministers have directed officials to prepare this policy within the timeframes of the 100 Days Plan. Accordingly, this analysis has been prepared within tight time constraints. 3. <u>Lack of empirical data:</u> The analysis on the impact of this policy on the housing market and on related markets is constrained by a lack of empirical data. Where empirical evidence is not available, a theoretical assessment of the expected impact has been provided. While some empirical data is available from the introduction of the bright-line test in 2015, it is difficult to isolate the impact of that policy change from other influences on the housing market at that time. 4. <u>Projected revenue figures:</u> The extended bright-line test does not raise any additional revenue in the first two years (as these sales are captured by the existing two-year bright-line provisions), but is estimated to raise in the vicinity of $50 million per annum once fully established. The caveats pertaining to the revenue forecast are as follows: • The revenue forecasts assume that the five-year bright-line test is introduced in February 2018. This means that revenue from the five-year bright-line only begins for properties sold after February 2020. Returns from these sales are processed from March 2021, but Residential Land Withholding Tax is immediately taxable, so 2020/21 is the ‘phase in’ year. • There is significant uncertainty in the revenue estimates, as they are sensitive to property price appreciation assumptions. The revenue estimates are based on an assumption of aggregate property price appreciation of approximately 3% per annum in nominal terms (consistent with the assumption in the forecasts for the Pre-Election Economic and Fiscal Update). • The revenue estimates are also contingent on the behavioural response to the policy. These estimates assume a reduction in property sales as the bright-line period approaches (i.e. those who defer the sale to avoid paying tax on it). However, there is a risk that this adjustment could either underestimate or overestimate the actual deferral of sales. • The extension of the bright-line test in the long run may decrease administrative costs, if the extended bright-line leads to improved voluntary compliance. As existing systems are in place for the two-year bright-line test, the additional short-run costs from the extension are not anticipated to be significant. However, officials have not been able to quantify the administrative costs in the time available.

Mark Vink

Tax Strategy

Economic System

The Treasury

[23 November 2017]

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

This proposal forms part of a suite of housing policies announced prior to the 2017 election, including a ban on foreign buyers, extending the bright-line to five years and ring-fencing rental losses.

The extension of the bright-line test from two years to five years is to ensure that residential property speculators pay tax on the gains from their activity. As the tax is expected to, at the margin, reduce speculative demand for housing, this would – all else equal – reduce house price pressure, which supports the other objective of improving housing affordability for owner-occupiers.

2.2 What regulatory system, or systems, are already in place?

The two-year bright-line test for the taxation of residential investment property is already in place. Since 1 October 2015, any residential property bought and sold within two years of this date is taxable under the bright-line test (with some exceptions, including the main home exemption which can be used up to twice in a two year period). In addition to the bright-line test, there are also other tax rules which determine whether the gains from the sale of property are taxable, typically determined by the purchaser's intention to profit at the time of sale or if they are engaged in regular property trading and/or development patterns.

Inland Revenue has begun reviewing tax returns and Land Transfer Tax Statement data for the period 1 October 2015 to 31 March 2016. This analysis suggests that about 4,700 property transfers during the period appear to involve residential property bought and sold within the two year bright-line period. Preliminary analysis of these transfers suggests that about:

- 2,700 (or 57%) appear to be exempt;
- 300 (or 6%) appear taxable under the two year bright-line test;
- 1,000 (or 21%) are taxable under other provisions; and
- 700 (or 15%) have yet to be checked.

The extension of the bright-line test will build on the existing regulatory systems already in place for the original two-year bright-line test.

2.3 What is the policy problem or opportunity?

While the gains on any residential investment property purchased with the intention to sell are taxable, the subjective nature of determining investors' intention makes this difficult to enforce.

The two-year bright-line test, introduced in 2015, captures the short-term (i.e. less than 2 years) speculation, but there is a risk that there is still speculative activity beyond this period that remains untaxed. Extending the bright-line test to five years reduces this risk and ensures that more residential property speculators pay their fair share of tax.

Housing has become less affordable throughout New Zealand, particularly in urban areas. The fundamental causes of unaffordable housing are constraints on the supply of housing, relative to demand. While it is recognised that improving the responsiveness of housing supply is required to address the affordability challenge, supply-side reforms will take time to have effect.

To the extent that housing affordability concerns are due to excess demand and some of this demand is from speculators, then reducing demand by speculators and investors, by ensuring they are taxed on any gains from residential property sales, may result in less upward pressure on house prices. This demand-side measure could help to reduce house price pressure until supply-side reforms take effect.

2.4 Are there any constraints on the scope for decision making?

As the Government has already publically indicated that it wishes to quickly move to legislate for an extended bright-line test. Officials have provided advice on the implementation of this policy in fulfilment of Ministerial direction. Thus, this analysis has been prepared on the basis that the decision to proceed on the extension of the bright-line test has already been made.

2.5 What do stakeholders think?

Due to time constraints, there has been no opportunity for formal consultation on the proposal to extend the bright-line test.

Section 3: Options identification

3.1 What options are available to address the problem?

As the Government has already announced its intention to extend the bright-line test from two years to five years, and Ministers have directed officials to prepare this policy within the timeframes of the 100 Days Plan, this analysis is focussed solely on the implementation of that proposal.

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 key criterion to measure the effectiveness of the policy against the Government's stated objective (that is, to ensure that residential property speculators pay tax on the gains from their activity) is to monitor tax compliance (which is already a function of Inland Revenue).

The other objective – that is, to improve housing affordability for owner-occupiers – is somewhat more complex and other criteria would need to be considered in-order to assess the impact of the policy on the housing market (and related markets).
To avoid false attribution, however, any changes observed in the relative share of different market segments would need to be isolated from other relevant variables, particularly other interventions targeted at reducing investor demand, which may be difficult to achieve in practice.

Different criteria would be required to indicate the adverse or unintended consequences of the extended bright-line test. For example, a reduction in the stock of rental property (controlling for other variables) may indicate that investors are leaving the market/reducing competition for owner-occupiers (although increasing competition for the remaining rental stock).

A trend towards longer holding periods for residential investment property (again, controlling for other variables) may be indicative of the 'lock-in' effect, particularly if there was an observable sales peak just after the 5 year mark (from investors) which may be indicative of avoidance behaviour.

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

The option of a capital gains tax (CGT) is outside the scope of this analysis. A comprehensive CGT may be considered by the Tax Working Group, and if implemented it could do away with the need for the extended bright-line test (i.e. all sales captured by the bright-line test would be captured by the CGT).

Section 4: Impact Analysis

Marginal impact: How does each of the options identified at section 3.1 compare with the counterfactual, under each of the criteria set out in section 3.2?

	No action			
Overall assessment				

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

Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?
Officials have not considered alternative options in the development of this policy. As the Government has already announced its intention to extend the bright-line test, this analysis is focussed solely on the implementation of that option.

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, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach, compared to taking no action			
Prospective speculators and investors	The impact on housing prices is ambiguous. Regardless of the absolute price level, the after-tax cost of property speculation will be more expensive to a speculator (who is not able to hold the property for over 5 years) compared to owner-occupier purchasers who will not be taxed on their gains. For the marginal speculator, the extended bright-line test would be the 'tipping point,' so they would forgo the purchase, as other alternative investments become relatively more attractive. The extended bright-line test reduces the after-tax return on speculative investment (if the property is sold within 5 years), but 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. All investors face some risk of being taxed under the bright-line, including those who did not acquire the residential property with an intention of resale. This could discourage	The impact on prospective speculators and investors is strongly dependant on the behavioural responses and on the availability of higher yielding alternative investment options. As these factors are not known, the impact on speculators and investors is not able to be quantified.	Low

	investors concerned that they may face unexpected circumstances that would lead them to have to sell before five years has passed.		
Residential property speculators and investors who sell between 2-5 years	Property speculators and investors who, by virtue of the timing and nature of their property sales, are taxed under the extended bright-line test bear the direct monetary cost of the tax for each property they sell.	The longer bright-line period, the greater the potential number of sales of residential property that will be subject to tax. However, some of the investors caught by the extended bright-line may not have acquired the property with an intention of resale. The precise impact is contingent on taxpayer behaviour and housing market conditions, but the extended bright-line test is expected to raise $50 million per year in the fifth year after coming into force. There is no additional revenue in the first two years following the change coming into force, as these sales are already covered by the existing bright line.	Medium
Residential property investors and speculators who delay the sale of their property to not get taxed	The extended bright-line test also increases the incentive for investors and speculators to hold on to their properties for a period exceeding five years. Speculators and investors seeking to not being taxed under the bright-line test 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 distortion may reduce their overall gain.	The size of this impact is uncertain, as it is contingent on the behavioural response of the investors and on broader market conditions.	Low
Existing property owners	To the extent that the extension of the bright-line test succeeds in reducing demand from speculators and investors, this reduction in aggregate demand for	Due to the lack of empirical data, this impact cannot be quantified, but it is expected to be marginal.	Low

	residential property at the margin may marginally reduce price pressures, all else equal. Existing property owners could be negatively impacted if the policy results in house prices being lower than they would have been otherwise.		
Rental property tenants	The extension of the bright line test may reduce the supply of rental accommodation if the tax discourages speculators and investors from investing in the rental market. Any reduction in the supply of rental accommodation is likely to increase rents (but will be offset to some degree as some renters take advantage of lower house prices to become owner-occupiers).	Due to the lack of empirical data, this impact cannot be quantified. The precise impact would depend on the behavioural response from renters. 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 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.	Low

Expected benefits of proposed approach, compared to taking no action			
Government	Increased revenue collected from the sale of residential investment property, as the extension of the bright-line test makes more sales as taxable.	The precise impact is contingent on taxpayer behaviour and housing market conditions. However, this change is forecast to earn about $50 million per year in the fifth year after coming into force. There is no additional impact in the first two years, as these sales are already covered by the existing bright line. Assuming the five-year bright-line test is	Medium

		introduced in February 2018 no additional revenue from the five-year bright-line test arises until properties sold after February 2020. Returns from these sales are processed from March 2021, but Residential Land Withholding Tax is immediate, so 2020/21 is the 'phase in' year. The extended bright-line test is expected to raise $10 million revenue in 2020/21, $30 million in 2021/22 and $50 million each year thereafter.	
Prospective first-home buyers	At the margin, reduced competition from speculators and investors in the market may reduce prices and make it somewhat easier for prospective first-home buyers to purchase a property. Prospective first home-buyers are, until the property is purchased, a subset of the rental market. As a group, prospective first home-buyers are likely to (on average) typically be older and have higher incomes than the 'median' renter, reflecting that it can take some time to accumulate savings for a deposit and the need to achieve a certain level of household income to service a mortgage.	Due to the lack of empirical data, this impact cannot be precisely quantified. It would depend on both market conditions and the behavioural response of market participants.	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. speculators and 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 speculators/investors (as noted above), there are wider externalities 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. From this efficiency perspective, a two-year bright-line test or a comprehensive CGT is likely to be preferable to a five-year bright-line test as the latter increases the risk of distorting timing decisions. 2. If the broader remit of what constitutes taxable speculative investment reduces demand from these types of investors, this may (all else equal) improve affordability for owner-occupiers (as they face less competition in the market from investors). The non-monetary impacts of increased homeownership can be positive, such as greater stability of tenure (and the associated secondary benefits), or negative, such as 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.

5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?
The extension of the bright-line test from two years to five years is expected to be relatively straightforward to implement. Inland Revenue's process for the current (two-year) bright-line period includes both manual and automated practices. An extension of the bright-line to five years may require more manual work until system solutions can be designed and implemented.

6.2 What are the implementation risks?
Although the extension of the bright-line test is expected to be relatively straight-forward to implement, it is not without implementation risks to be managed. The key implementation risks are as follows: • Non-compliance risks: High level analysis of taxpayer compliance with the existing bright-line legislation suggests that voluntary compliance with the existing rules appears to be less than 50%. Non-compliance will still be an issue if the bright-line test is extended over a longer period. To manage the risk of non-compliance (and reduce the associated consequences on revenue and taxpayer fairness), Inland Revenue has visibility of property sales and is following up on cases of apparent non-compliance. Inland Revenue is also considering changes to existing processes that could drive up voluntary compliance. • Capital gains tax: The Tax Working Group may consider a CGT which, if implemented, could supersede the bright-line test.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
In September 2017, Inland Revenue completed a property compliance activities evaluation baseline report. This work considered all of Inland Revenue's property compliance activities since legislative changes to property tax were introduced in 2015. The bright-line rules were brought in due to concerns that Inland Revenue had difficulty in enforcing the current land sales rules, in particular the intention test. Inland Revenue will continue to evaluate its programmes in terms of taxpayer compliance with the current law, including the bright-line test. Because of the attribution challenges (i.e. the practical difficulties of isolating the effect of the extended bright-line test from the multiple endogenous and exogenous variables influencing the housing market), there are no specific monitoring and evaluation measures for this policy alone, but officials will monitor the general housing market indicators collected by MBIE.

7.2 When and how will the new arrangements be reviewed?
The extension to the bright-line period will be incorporated into the relevant Inland Revenue annual evaluation work as appropriate.