

Impact Summary: Land tax rules review 2019 – habitual buyers & sellers

Section 1: General information

| Purpose |
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| Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Assessment (RIA), 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. |

| Key Limitations or Constraints on Analysis |
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| <p>There are a number of limitations or constraints. These are:</p> <ul style="list-style-type: none">• There is no data to confirm that the issues the policy proposals are intending to address are currently a problem. Instead, officials have identified a gap in the current legislation that may be exploited by taxpayers considering recent and ongoing changes to tighten the rules for taxing land disposals. On that basis, officials consider that it is important to address these issues at this time.• Options have been limited to considering making the current framework more effective. Officials did not consider options that would tax more categories of land.• The lack of data on the scope and scale of taxpayer practices and structuring makes it difficult to determine which options best address the problem.• The lack of data means that no qualitative impact analysis is possible. However, problem definition and solutions were subject to targeted and public consultation. |

| Quality Assurance Reviewing Agency: |
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| Inland Revenue |

| Quality Assurance Assessment: |
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| <p>The Quality Assurance reviewer at Inland Revenue has reviewed the <i>Land tax rules review 2019 – habitual buyers & sellers</i> RIA and considers that the information and analysis summarised in it partially meets the quality criteria of the Regulatory Impact Analysis framework.</p> <p>As identified in the Key Limitations or Constraints on Analysis section there is no data to support the current scale of the problem or the impact of the proposed changes if they were</p> |

enacted. However, the RIA sets out the rationale for why the status quo is an issue and why a regulatory change is preferred. The reviewer considers that the information in the RIA is as complete as could be expected and identifies the main risks and uncertainties.

Reviewer Comments and Recommendations:

The reviewer's comments on earlier versions of this RIA have been incorporated into this version.

Responsible Manager (signature and date):

Peter Frawley
Policy Lead
Policy and Strategy
Inland Revenue
19 November 2019

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

This RIA considers proposals to tighten the rules that apply where people regularly buy and sell land that is used mainly as a home or business premises while it is held by them.

Current situation

The land sales rules contained in part CB of the Income Tax Act 2007 tax gains from the sale of land when the land is held by a person effectively as trading stock (in the same way that a furniture vendor is taxed on the gains they make from selling their furniture). It is not intended that the rules tax gains on capital assets (e.g. gains from selling the furniture vendor's shop or a person's home). However, the rules are drafted quite broadly to ensure that people cannot easily structure around them, which means they can catch some land that is inherently a capital asset.

To limit this potential overreach, the rules contain exclusions. Relevantly, the rules exclude from tax gains from the sale of:

- a person's main home, where land sales are subject to tax under the bright-line test¹ (the main home exclusion)
- a person's residence, where land sales are subject to tax because the land was acquired with an intention of disposal, or where the owner or an associated person is in a business involving land (the residential exclusion)
- a business premises, where land sales are subject to tax because the land was acquired with an intention of disposal, or where the owner or an associated person is in a business involving land (the business premises exclusion).

For example, the land sales rules tax all sales of land by a land dealer, but the exclusions ensure the dealer will not be taxed on the sale of their home.

To ensure these exclusions are not abused, they are subject to regular pattern restrictions which stop the exclusions applying where a person has a regular pattern of buying and selling land used as a main home, residence or business premises. The regular pattern restriction in the main home exclusion for the bright-line test is also supplemented by a time-period rule, which states that the main home exclusion will not apply if a person has relied on it twice in the previous two years.

These restrictions ensure that people who regularly buy and sell land effectively as trading stock cannot rely on the exclusions to escape tax.

Why is the current situation a problem?

Given the recent tightening of the land rules² there is a concern that taxpayers can avoid the regular pattern restrictions by arranging their affairs so they do not have a pattern of buying and selling main homes, residences or business premises. This is contrary to the policy intention.

¹ The bright-line test taxes gains from the sale of residential land acquired and sold within five years.

² Including the introduction of the bright-line test and the new residential rental ring-fencing rules that only allow deductions to be offset against income derived from land (e.g. rental income).

The risk is that the government is missing out on tax revenue from those that are effectively making trading profits from the buying and selling of land, but are relying upon the main home, residential or business premises exclusions to escape tax. Over time there is a risk that greater numbers of investors may become involved in trading homes and business premises to take advantage of the tax-free gains. We are unable to estimate the size of the current tax gap or how this could change with increased investor activity.

The general anti-avoidance rule (GAAR) will continue to effectively override other provisions of the tax legislation to deny the tax benefits of an arrangement where a more than incidental purpose of the arrangement is to obtain a tax benefit. In some circumstances the GAAR could be invoked where a taxpayer has structured their affairs in such a way that they have avoided establishing a regular pattern of purchase and sale of home or business premises.

However, in many circumstances the GAAR may not be the most effective tool to counter such structuring. It is considered preferable for there to be clarity and transparency in the underlying law to give certainty to both taxpayers and Inland Revenue.

What is the underlying cause of the problem?

Officials have concerns that the current regular pattern restrictions are not working as intended. This undermines the integrity of the tax system by allowing people to take advantage of the exclusions in circumstances where this was not intended.

As the restrictions are currently drafted, taxpayers who are undertaking regular buying and selling activity can structure around the regular pattern restrictions in one of two ways.

Firstly, the regular pattern restrictions apply quite narrowly to the activities of a single person. This allows taxpayers to circumvent the application of the regular pattern restrictions by buying and selling land using different persons or entities each time (for example, the first property is purchased by the person, the second is purchased by their partner, the third by their family trust).

Secondly, the regular pattern restrictions have been interpreted narrowly to apply only when there is a similarity or likeness between the transactions (for example, a pattern of buying land, building a home on the land and then selling). This means that the regular pattern restrictions will not apply where a person does something different to each piece of land. For example, the first property is bought, lived in and sold, the second is renovated while it is lived in and sold, or the third is a bare section where a house is built and occupied then sold.

Why does it need to be addressed now?

The Government has indicated that people who engage in property speculation will come under increasing scrutiny. This is why a review of the land rules was added to the Government's Tax Policy Work Programme earlier in the year. One of the aims of this review is to consider ways to improve the integrity of the tax system.

How much confidence is there in the evidence and assumptions for the problem definition?

While there is currently no data, to the extent that there is currently a gap in the current land rules, it is reasonable to assume that some investors will look to exploit the existence of tax-free gains.

Other context

The issues considered in this RIA have been identified as part of a review of the current land tax rules undertaken by Inland Revenue. As part of this review, other regulatory changes

have been identified, including:

- clarifying the extent to which holding costs (such as interest, rates and insurance) should be deductible when the gain from the sale of private use land (such as a bach) is taxable; and
- moving the requirements of the Land Transfer Tax Statement (a form filed with Land Information New Zealand (LINZ) when people buy, sell or transfer property) from the Land Transfer Act 2017 to new secondary regulations operated by LINZ to provide a more flexible way to make any future changes to the form.

A second tranche of the land review is planned which will include consideration of the following:

- extending the bright-line test to farmland and commercial properties;
- extending Residential Land Withholding Tax to New Zealand residents;
- reviewing the re-zoning rule;
- reviewing the land tax frameworks;
- considering the introduction of a vacant land tax; and
- various compliance and administration matters.

2.2 Who is affected and how?

The group of people potentially affected by tightening the rules are taxpayers who regularly buy land to be used mainly as a home or business premises and then sell that land.

The proposed regulatory changes seek to clarify and support, rather than depart from, existing policy in the area by ensuring that the regular pattern restrictions apply to people who regularly buy and sell land to stop them escaping tax.

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

The Government announced in April 2019 that it would not be proceeding with a capital gains tax, but that other initiatives to improve the fairness of the tax system would be considered, including tightening the rules around land speculation and working on ways to counter land banking.

Section 3: Options identification

3.1 What options have been considered?

This RIA deals with proposed regulatory changes to tighten the rules that relate to regular buying and selling of homes and business premises to ensure people cannot escape paying tax by relying on the exclusions where that was not intended. The proposals have arisen in the context of the review of the current land tax rules, to meet the Government's objectives of improving the efficient use of land, and ensuring that tax settings are fair, balanced, and encourage and support productive investment.

All options are assessed against the following criteria:

- a) **Integrity of the tax system:** the tax rules should operate so as to collect revenue where intended.
- b) **Effectiveness:** the tax rules should produce the right amount of tax at the right time; the potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved.
- c) **Fairness:** the tax rules should not be arbitrary and should be fair to different taxpayers.
- d) **Certainty and simplicity:** the tax rules should be as clear and simple as possible so that taxpayers who attempt to comply with the rules are able to do so.

Increasing the integrity of the tax system is a primary objective of these changes. However, it is necessary to balance this objective against ensuring that the rules are effective, fair and balanced, and that they provide certainty and simplicity for taxpayers.

Group of persons or entities

The current regular pattern restrictions apply when a single person (which includes a company, trust or other entity type) has a pattern of buying and selling. This limited application gives rise to a risk that taxpayers can structure around the regular pattern restrictions by using other persons or entities to carry out each transaction, rather than carrying out multiple transactions on their own.

Option 1: Status quo

The first option is to maintain the status quo, so the regular pattern restrictions continue to apply only to the actions of a single person.

This option undermines the integrity and effectiveness of the tax system because it allows taxpayers to structure around the rules to avoid tax. It also unfair as it benefits those taxpayers who are willing and able to structure around the rules.

However, remaining with the status quo could be said to be a simpler option, and would avoid the need for more complex rules.

Option 2: Extend the regular pattern restrictions to groups of people

The second option is to expand the regular pattern restrictions to apply to groups of people, as follows:

- For the residential exclusion, a group of people will be undertaking buying and selling activity together if they all occupy all of the properties as their residence, or if the people who occupy all of the properties as their residences control the trusts or other entities that own the properties.
- For the business premises exclusion, a group of people will be undertaking buying and selling activity together if they are all controlled by the same person or persons (e.g. all the companies have the same shareholders).

This option will protect the integrity and effectiveness of the tax system by ensuring that people cannot structure to avoid their tax obligations. It will also ensure that taxpayers pay their fair share of tax.

However, these changes will introduce further complexity to the rules.

Similar activities

The current regular pattern restrictions have been interpreted as only applying when there is a similarity or likeness in the transactions. There is a concern that this allows taxpayers to structure around the regular pattern restrictions by carrying out different activities on each piece of land so there is not sufficient similarity or likeness in the transactions.

Option 1: Status quo

The first option would be to maintain the status quo.

This option undermines the integrity and effectiveness of the tax system because it allows taxpayers to structure around the rules to avoid tax. It is also unfair as it benefits those taxpayers who are willing and able to structure around the rules.

Option 2: Focus on regularity of transactions

The second option is to amend the rules to capture patterns of buying and selling, with the focus being on the regularity of the transactions, rather than on the similarity or likeness of what is done on the land.

This option will protect the integrity and effectiveness of the tax system by ensuring that people cannot structure to avoid their tax obligations. It will also ensure that taxpayers pay their fair share of tax.

This option will reduce complexity and add clarity to the legislation by simplifying the factors that must be satisfied before the restriction will apply.

Intention test

The residential and business premises exclusions currently apply both:

- when a person acquired land with a purpose or intention of disposal or for business involving land; and
- for disposals of land within 10 years when a person is associated with a person who carries on a business involving land.

Therefore, it is possible that the current regular pattern restrictions could result in a person who is associated with a land dealer being taxed on the sale of their home or business premises because they have been forced to move for family or business reasons several times over a couple of years.

It has been proposed by submitters that the regular pattern restrictions could be limited to situations where the land has been acquired with a purpose or intention of disposal.

Option 1: Status quo

The first option is to maintain the status quo and continue to apply the regular pattern restrictions to situations where a person is associated with a person in a business involving land.

In the context of the other proposed amendments, this option has the potential to be unfair, because it risks capturing sales of genuine homes and business premises. The potential for unfairness undermines the integrity of the tax system, and heightens the risk of tax avoidance and evasion as taxpayers seek to escape a tax they consider unfair.

However, retaining the status quo could be seen as being simpler as it applies the same rules to all taxpayers who are subject to the exclusions.

Option 2: Introduction of intention test

The second option is to limit the application of the regular pattern restrictions to situations where the owner of the land acquired it with an intention of disposal.

This option improves the integrity of the tax system in that it helps to ensure the rules only operate to collect revenue where intended. It also improves the effectiveness and fairness of the tax system by only taxing true revenue gains.

The introduction of a further limitation will, however, add some complexity to the rules.

Amending the business premises regular pattern restriction

The business premises exclusion applies only where the owner of the land mainly uses the land to carry on a substantial business. Because the business premises exclusion is limited in this way, it has been suggested by submitters that it is already hard to structure around and does not require amendment to cover activities by a group of people.

Option 1: Status quo

The first option is to maintain the status quo.

This option is simple because it will not require complex grouping rules.

However, this option risks allowing taxpayers to structure around the regular pattern restriction, which reduces the integrity and effectiveness of the tax system. It could also be argued that not amending the business premises exclusion if the residential and main home exclusions are amended (as proposed above) would be unfair in that it would allow those owning land for business purposes advantages over those owning land for residential purposes.

Option 2: Amend the business premises regular pattern restriction

The second option is to amend the regular pattern restriction in the business premises exclusion to apply when a person, or a group of people or entities that are all controlled by a person or group of persons, regularly buy and sell land used as business premises.

This option would improve the integrity, effectiveness and fairness of the tax system by ensuring that taxpayers cannot avoid tax by using separate entities to carry on buying and selling activities where those activities would be subject to tax if they were carried on by one

person alone. By doing so, it will better ensure that the right amount of revenue is collected over time.

This option also improves clarity for taxpayers by clearly indicating activity that should be subject to tax.

This option will, however, not be simpler because it will require relatively complex rules to capture the intended group of people or entities.

Time-period rule

The regular pattern restriction in the main home exclusion for the bright-line test is supplemented by a time-period rule, which states that the main home exclusion will not apply if a person has relied on it twice in the previous two years. This time-period does not appear in the residential and business premises exclusions. To attempt to provide clarity and objectivity, a similar time-period rule could be added to the residential and business premises exclusions.

Option 1: Status quo

The first option is to maintain the status quo and have no time-period restrictions in the residential and business premises exclusions.

This option is simple but leaves uncertainty in the rules because the current rules are subjective making them harder to apply.

However, this option is more likely to maintain the integrity of the tax system by ensuring that transactions would not be subject to tax simply due to volume. In doing so, it would also ensure that the rules are perceived to be fair.

Option 2: Add time period restrictions

The second option is to add time-period restrictions (i.e. the exclusions will not apply if they have been used twice in two years) to the residential and business premises exclusions.

This option could add clarity to the rules because it would introduce an objective test to apply. However, introducing an extra provision decreases the simplicity of the rules.

However, this option could reduce the integrity of the tax system as it risks taxing sales of genuine homes and business premises merely due to the level of transactions undertaken with no consideration given to the person's intention.

3.2 Which of these options is the proposed approach?

Officials consider that the following amendments to the regular pattern restrictions are the best options to resolve the issue:

Group of persons or entities

Recommendation: Option 2 - Extend the regular pattern restrictions to groups of people

The regular pattern restrictions should be extended to apply to a person or a group of persons that undertake buying and selling activity together:

- For the residential exclusion, a group of people will be undertaking buying and selling activity together if they all occupy all of the properties as their residence, or if the people who occupy all of the properties as their residences control the trusts or other entities that own the properties.
- For the business premises exclusion, a group of people will be undertaking buying and selling activity together if they are all controlled by the same person or persons (e.g. all the companies have the same shareholders).

This will protect the integrity and effectiveness of the tax system by ensuring that people cannot structure to avoid their tax obligations. It will also ensure that taxpayers pay their fair share of tax.

Similar activities

Recommendation: Option 2 - Focus on regularity of transactions

The regular pattern restrictions should be extended to apply more broadly to any pattern of buying and selling land used as a residence or business premises. It should not matter whether properties were simply bought and sold, or whether any building or renovation work occurred while the person owned the land. What should be relevant is that there are “regular” transactions (that is, the transactions occur at sufficiently uniform or consistent intervals).

This will ensure that the regular pattern restrictions are no longer restricted to applying only where there is a similarity or likeness between the transactions (for example, a pattern of buying land, building a home on the land and then selling). This will increase the integrity of the tax system.

Intention test

Recommendation: Option 2 - Introduce intention test

The regular pattern restrictions in the residential and business premises exclusions should be targeted so they only apply where the person acquired the land with an intention of disposal.

Expanding the regular pattern restrictions gives rise to an increased risk that they could catch ordinary residential transactions that occur for family reasons, and small businesses who are upgrading as their business grows because the person is, or is associated with, a person in a business involving land. Officials consider that the regular pattern restrictions should be limited to ensure that people who regularly buy and sell land effectively as trading stock cannot use the home or business premise exclusions to escape tax.

This option improves the integrity of the tax system in that it helps to ensure the rules only operate to collect revenue where intended. It also improves the effectiveness and fairness of the tax system by only taxing true revenue gains.

Amending the business premises regular pattern restriction

Recommendation: Option 2 - Regular pattern restriction in the business premises exclusion should be amended

The regular pattern restriction in the business premises exclusion should be amended to apply to activities by a group of people or entities.

Under the current rules, a single person cannot escape tax by using land acquired as trading stock as a business premises while they hold it. This outcome should not be able to be structured around by using a group of entities controlled by a person. The proposed changes will ensure this is the case.

The main concern raised by submitters appeared to be the concern of overreach. Officials consider that this risk is mitigated by limiting the regular pattern restrictions, so they only apply when land is acquired with an intention of resale.

Time-period rule

Recommendation: Option 1 - Status quo

A time-period rule such as that included in the bright-line main home exclusion is not appropriate for the residential and business premises exclusions.

In the context of the bright-line test, which taxes sales without consideration of intention, presuming the exclusion should not apply simply because there were multiple transactions within a defined period can be justified. However, regularity alone should not be enough to give rise to a taxable transaction under the other provisions. Instead, it is important that the owner also has an intention of disposal.

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

| Affected parties <i>(identify)</i> | Comment: nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks | Impact <i>\$m present value, for monetised impacts; high, medium or low for non-monetised impacts</i> |
|--|---|---|
|--|---|---|

Additional costs of proposed approach, compared to taking no action

| | | |
|--|---|--|
| Taxpayers who regularly buy land, use it as a main home, residence or business premises and then sell it, structuring the transactions around the regular pattern restrictions as the legislation is currently drafted | <p>Will need to return the disposal of land for tax purposes. There will be an increase in income tax paid, however, this is difficult to quantify</p> <p>Possible decrease in number of houses purchased, renovated and then sold within a short space of time</p> | <p>Cannot be quantified</p> <p>Cannot be quantified</p> |
| Regulators | It is expected that the changes can be managed as part of Inland Revenue's business as usual legislative change. Therefore, no additional funding is required to support this change. | Nil |
| Total Monetised Cost | | Increase in income tax paid but unable to be quantified |
| Non-monetised costs | | Possible decrease in houses being renovated; possible decrease in number of houses being sold (unquantifiable) |

Expected benefits of proposed approach, compared to taking no action

| | | |
|--------------------------------|---|---|
| Wider government | The policy changes will be fiscally positive. However, the impact cannot be quantified. | Increase in tax (unable to be quantified) |
| Total Monetised Benefit | | Increase in income tax paid but unable to be quantified |
| Non-monetised benefits | | N/A |

4.2 What other impacts is this approach likely to have?

There are no other identified impacts of this approach.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

Consultation document

Officials issued a consultation document “Habitual buying and selling” in September 2019 setting out the issues and proposing possible solutions and asked for taxpayers’ views on the proposals. Prior to releasing the document publicly, officials also tested their thinking with some private sector advisors.

Feedback

In general, submitters appear to understand officials’ concerns that taxpayers can structure around the regular pattern restrictions, and most supported changes in the area. However, almost all submitters expressed concerns about the potential for overreach from the proposed amendments and, in particular, that the amendments risk taxing transactions that should not be subject to tax (i.e. sales of genuine homes or business premises).

Submitters also disagreed with proposals to amend the regular pattern restriction in the business premises exclusion. They submitted there was no evidence of any abuse of that exclusion.

Submitters could see that a time-period rule may be useful to supplement the regular pattern restriction in the residential exclusion. However, there was concern that a time-period rule would be arbitrary and could not accommodate factors outside a person’s control.

Submitters’ views and concerns were taken into account by officials in forming the preferred views discussed above. In particular, officials addressed submitters’ concerns around overreach i.e. that the proposals risk taxing the sale of homes or business premises for genuine reasons. In response to those concerns, officials propose to target the regular pattern restrictions to situations where there is an intention of resale.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?

The proposals will require amendments to the Income Tax Act 2007 which could be included in the omnibus tax Bill scheduled to be introduced in early 2020.

The changes should apply prospectively, i.e. only properties acquired and sold after the application date would be taxable. However, properties acquired before the application date would be able to be considered for the purposes of determining whether a taxpayer has a regular pattern.

Inland Revenue will release details of the Cabinet decision once it is made and further detail will be provided in a commentary released when the Bill is introduced and will also be included in the Tax Information Bulletin after the Bill is enacted.

Inland Revenue will be responsible for the ongoing monitoring and enforcement of the rules.

Section 7: Monitoring, evaluation and review

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

Inland Revenue undertakes regular review of land transactions via its Property Compliance Programme (PCP), which is aimed at ensuring that those involved in property dealing or speculation pay their fair share of tax. Inland Revenue undertakes regular reporting to government as part of the PCP.

Inland Revenue is also developing a Data Intelligence Platform (DIP) to enable right-time interaction and appropriate risk-based interventions, by identifying affected customers, understanding customer behaviours and needs, and highlighting areas of compliance focus as well as policy weakness, including how these matters relate to land. The DIP will be able to pull in relevant sources of data and can be used to identify certain types of customer groups, build customer profiles and understand the problem in a wider context. However, as with any other information system it will be dependent upon the personnel, data available and cases run in order to deliver its potential value.

The DIP will continue to be developed to further refine Inland Revenue's ability to target particular transactions including assisting Inland Revenue in monitoring whether the exclusions are operating as intended, and educating taxpayers on the matter as appropriate.

7.2 When and how will the new arrangements be reviewed?

Inland Revenue would closely monitor the effectiveness of the proposed changes as part of the PCP programme.

The final step in the Generic Tax Policy Process is the implementation and review stage, which involves post-implementation review of legislation, and the identification of remedial issues. A post-implementation review could occur around two years after the tax year that the amendments first apply.

Any recommended changes identified from the review would be considered for potential inclusion on the Government's tax policy work programme.