

Regulatory Impact Statement

Bright-line test for sales of residential property

Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

It provides an analysis of options for the detailed design and implementation of the proposed “bright-line test”.

On 14 May 2015, the Government announced plans to introduce a bright-line test to help buttress the current “intention test” in the current land sale rules. The “intention test” makes gains from the sale of land taxable when bought with an intention of resale. This “intention test” is difficult to enforce due to its subjectivity. This test is particularly difficult to enforce in relation to residential property because of its high volume and churn.

This analysis was informed by public feedback on proposals contained in the officials’ issues paper *Bright-line test for sales of residential property*, which was released on 29 June 2015. Fourteen submissions were received on the issues paper. Submissions generally focused on the design of the bright-line test and raised concerns regarding the complexity of the rules and departures from existing land sale rules. Several changes have been made to the design of the bright-line test in response to submissions, and to provide greater clarity in the rules.

Exact figures for the fiscal and compliance cost impacts are not available because Inland Revenue does not currently have accurate data on the types and levels of land sales occurring or how much is collected currently from the land sale rules. The data for these areas is expected to improve as new information disclosure requirements for property come into force and Inland Revenue implements a new form to better monitor taxable land sales.

The options identified would not impair private property rights, restrict market competition, reduce incentives on businesses to innovate and invest, or override fundamental common law principles.

The options which introduce a bright-line test will impose additional costs on businesses when they have sales subject to the bright-line test which would not otherwise have been taxable. We consider that this impact is likely to be minor, and is potentially balanced out by the reduced compliance costs for those who would otherwise have been caught by the “intention test” but the bright-line test makes this position clearer.

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STATUS QUO AND PROBLEM DEFINITION

1. The Government is concerned with high house prices, particularly in the Auckland area. Property speculation is seen as one of a number of causes of the current prices. Other possible causes, both on the supply and demand sides, are being separately considered. The attractiveness of property speculation, when compared with other forms of investment increase, if the gains are able to be realised untaxed, when gains from other investments are taxed.

Residential property churn

2. There is significant churn and short term speculation in residential property, particularly in Auckland.

Share of Auckland dwelling sales within 1, 2, and 3 years

Sold within	Share of sales	Std error	Confidence interval
1 Year	8.4%	0.2%	8.0%-8.7%
2 Years	17.4%	0.3%	6.9%-17.9%
3 Years	26.1%	0.3%	25.5%-26.7%

Source: MBIE analysis of Corelogic data

3. In addition to this, there is evidence of particularly fast churn for new titles and developments in Auckland. The evidence suggests, from 2009-2013 59% of all new titles were disposed of within a year and 29% of new developments in North Auckland were traded within 3 months.

Income tax compliance

4. The Income Tax Act 2007 contains provisions that impose income tax on certain property transactions. The key provision that imposes income tax on property transactions is section CB 6, which taxes land bought with an intention or purpose of disposal.

5. This “intention test” is difficult to enforce as it relies on a judgement about a taxpayer’s subjective intention. In addition the high volume of transactions in residential property creates additional difficulties in enforcing the “intention test”. Investigators in Inland Revenue report this means that the scale of transactions has to be close to that of a business before they can be certain that the land sale rules apply.

6. As a result, investigations by Inland Revenue suggest that many people whose gains from the sale of land are taxable are not returning this income. The Government is concerned about this non-compliance.

Bright-line test

7. To address these concerns, the Government, as part of Budget 2015, announced a series of measures aimed at providing clearer tax rules for property transactions and providing more useful information to Inland Revenue to assist in its enforcement of those rules. There was also increased funding to Inland Revenue to investigate people who may not be correctly returning income from taxable property sales. The main change is the introduction of a “bright-line” test that will, in general terms, make the disposal of residential property taxable if the property is bought and sold within a two-year window (subject to certain exceptions).

8. The bright-line test was seen as a way to deal with the issue of property speculation in the short-term and to help buttress the “intention test”.

9. In order to provide more useful information to Inland Revenue to enforce the tax laws, two further changes were announced:

a) Vendors and purchasers will generally be required to provide their IRD numbers (and, if they are tax residents of another jurisdiction, also provide their foreign tax identification number) at the time of transfer.

b) The second proposal is that an offshore person will be required to provide evidence of a New Zealand bank account as a prerequisite to obtaining an IRD number.

10. These changes were canvassed in the regulatory impact statements *Sellers and purchasers of real property required to supply their IRD numbers and tax information numbers*, and *Requiring non-resident IRD number applicant to have a New Zealand bank account*.

11. This RIS deals with the main change: the bright-line test. Specifically it deals with the question of how best to design and implement a bright-line test in order to ensure that it meets the stated objectives.

12. The Government directed the Treasury and Inland Revenue to explore options of how best to design and implement a bright-line test. This led to the release of the Officials’ Issues Paper *Bright-line test for sales of residential property*. The issues paper proposed a two-year bright-line test with the following key design features:

- The two-year period for the bright-line test runs from the date a person has title for the property transferred to them and ends at the time the person enters in a contract to sell the property. An additional rule applies for sales “off the plan”.
- The bright-line test will apply only to residential land. Residential land includes land where there is an arrangement to build a dwelling on it. Residential land does not include business premises or farmland.
- The bright-line test will generally not apply to a person’s main home. A person can only have one main home. The main home exception applies to properties held in trust. There are rules preventing trusts being used to obtain the exception for multiple properties.
- The bright-line test will not apply to property acquired through an inheritance and rollover relief is available for property transferred under a relationship property agreement.
- Losses arising from the bright-line test will be ring-fenced so they may only be used to offset taxable gains from other land sales.
- A specific anti-avoidance rule applies to counter companies and trusts being used to circumvent the bright-line test.

OBJECTIVES

13. The objectives are:

- a) Provide an easier rule for Inland Revenue to enforce to target short-term speculation in residential property.
- b) Minimise the number of sales made taxable that were acquired without an intention of resale.
- c) Minimise compliance costs for taxpayers in complying with the bright-line test.

14. The first objective is to provide an easier to enforce rule to supplement the current “intention test”. This is particularly targeted towards the problems of enforcement in relation to short-term property speculation.

15. As the primary goal is to supplement the existing “intention test”, the second objective is to minimise the degree to which any rule captures the gains from sales not bought with an intention of resale.

16. The third objective is to minimise compliance costs for taxpayers. This will involve minimising the complexity of the rules, making them easy to understand as well as aligning the rules with the existing land sale rules where possible.

17. These three objectives may conflict. An easy to enforce rule may make the gains from some sales taxable when the property was not bought with an intention of resale. In addition, rules that are easier for Inland Revenue to enforce can increase compliance costs for taxpayers in some circumstances. The analysis will need to balance these objectives.

REGULATORY IMPACT ANALYSIS

18. Two options for designing a bright-line test are considered below.

- Option 1: Two year bright-line test
- Option 2: Three to five year bright-line test

19. We note that as the Government announced that it will introduce a bright-line test we did not consider the status quo to be a viable option.

Option 1 (officials’ preferred option)

20. This option would create a rule that requires income tax to be paid on the gains from the sale of residential property bought and sold within two years. The intention test would still make gains from the sale of land taxable if bought with an intention of resale.

21. This would supplement the intention test with an unambiguous objective test. As a result, it would make the land sale rules easier to enforce.

22. The objective nature of the rule means that it would capture people with no intention of resale but are forced to sell due to circumstances outside of their control. However, we consider this risk is low, as generally when property is bought and sold within two years it is likely to have been purchased with an intention of resale.

23. This rule is expected to raise an additional \$5 million per annum in addition to any income expected from property compliance audit activity.

24. This option creates an economic distortion as it creates a “lock-in” effect. In other words, it creates an incentive for people to hold property for longer than two years to avoid the bright-line test. For example, a person may avoid selling a property at the highest price, within two years to avoid the bright-line test. The person who is offering the highest price can presumably put the property to its most valuable use. This means that people may not undergo otherwise efficient transactions and put property to its most valuable use due to the bright-line test.

25. On balance we consider that a two-year bright-line period best balances the competing objectives of having an easy to enforce rule to deal with the short-term speculation in residential property while ensuring that it does not capture many sales that were acquired without an intention of resale.

26. This is Inland Revenue’s preferred option.

27. There are a number of detailed design issues with this option. These design issues have large impact on the degree to which this option meets the objectives.

28. These detailed design issues are considered in the section “further analysis of options 1 and 2”.

Option 2

29. This option would create a bright-line similar to option 1, however with the period of the bright-line being longer at potentially three or five years rather than two years.

30. This option has similar impacts as option 1 but with greater effect owing to its longer period. It would best meet the objective of creating an easy to enforce rule and would have the greatest positive fiscal and administrative impact.

31. However, this option has the greatest risk of capturing sales that were acquired without an intention of resale.

32. As a result, this is not Inland Revenue’s preferred option.

33. There are a number of detailed design issues with this option, these are considered in the section “further analysis of options 1 and 2”.

Summary of analysis of options

34. The table below summarises the impact analysis of the options.

Option	Meets objective?	Impacts					Net impact
		<i>Fiscal</i>	<i>Economic</i>	<i>Administrative</i>	<i>Compliance</i>	<i>Fairness</i>	
1 – Two year bright-line	<p>Meets objective (a)</p> <p>Largely meets objective (b)</p> <p>Partially meets objective (c)</p>	<p>The 2 year bright-line is expected to raise an additional \$5 million per annum, which is based on a number of behavioural assumptions, which are inherently difficult to quantify, such as the number of sales that would be delayed in order to exceed the two-year holding period. The actual revenue collected under this option may be significantly more if the behavioural responses are different to those assumed.</p>	<p>This option would create a “lock-in” effect as people have an incentive to hold property for longer than 2 years.</p> <p>This would result in an economic distortion as people may not undergo otherwise efficient transactions due to the bright-line test.</p>	<p>This option creates an easier to enforce rule which will decrease administration costs for Inland Revenue.</p>	<p>Compliance costs will decrease for people currently taxed under existing rules as this option reduces ambiguity.</p> <p>Compliance costs will increase for other people caught by the bright-line as they have new tax obligations.</p>	<p>The bright-line test will make enforcement easier and help ensure people pay their fair share of tax.</p> <p>May be seen as unfair as persons who sell within two years are treated differently from those who are able to delay their sale beyond two years.</p>	<p>Ensures the key difficulty of enforcement where there is a high churn of properties is targeted while not capturing significant numbers of persons who had no intention of resale.</p>
2 – Three or five year bright-line	<p>Best meets objective (a)</p> <p>Least meets objective (b)</p> <p>Partially meets objective (c)</p>	<p>No estimate of revenue gain has been made, but we expect it would be greater than the \$5 million estimated for option 1.</p>	<p>This option would have similar lock-in effects to option 1.</p>	<p>This option would have the greatest impact in reducing the administration costs involved in applying the “intention test” for Inland Revenue.</p>	<p>Compliance costs would likely be greater than for option 1. This is because additional sales will be caught by the rules which are less likely to be taxable under the current rules.</p>	<p>This option has similar fairness impacts as option 1.</p>	<p>Provides easiest to enforce measure of the options. However, it is likely to capture significant numbers of persons who had no intention of resale.</p>

Further analysis on options 1 and 2 – detailed design of bright-line test

35. There are a number of design issues for the bright-line test which require separate impact analysis. The analysis is summarised in the tables below.

36. The design of the bright-line test is intended to support the objectives. The design is based on having clear objective rules and as a result there are few exceptions and where there are exceptions they are tightly defined. This helps to ensure that the bright-line test is clear and unambiguous.

Start and end dates for bright-line

37. Determining the start and end dates for the bright-line involves a trade-off between providing rules that are easy for Inland Revenue to enforce and avoiding complexity through creating rules inconsistent with the existing land sale rules.

Issue	Options	Advantages	Disadvantages	Recommendations
Start date	<i>Date agreement for sale and purchase entered into</i>	Little scope for manipulation. Consistent with existing land sale rules and therefore easier to comply with	Creates uncertainty at point of sale as this date may not be known to seller or IR at point of sale	Not recommended Difficult for Inland Revenue to enforce
	<i>Date of registration of title</i>	Clear date recorded on Landonline	Is the last stage in purchase process so could be perceived as unfairly shortening bright-line	Recommended Clear and easy to apply rule
End date	<i>Date agreement for sale and purchase entered into</i>	Until this date, seller does not have legal rights against the purchaser. As a result there is less scope for manipulation	Less clear than registration as not recorded on Landonline	Recommended
	<i>Date of registration of title</i>	Clear date recorded on Landonline	Scope for manipulation – it is possible to artificially defer this date.	Not recommended Too easy to manipulate

Residential land

38. The bright-line test could apply either to all land or just to residential land. The key trade-off between these two options is between targeting the bright-line test to the main issue of high churn of residential property and creating a difficult boundary.

Options	Advantages	Disadvantages	Recommendations
<i>Apply bright-line to all land</i>	Removes difficult boundary questions in defining residential land	Is not as well targeted towards main issue of high churn of residential property. The lock-in effect is greater as it affects businesses decisions whether to replace their commercial property with more productive premises.	Not recommended
<i>Apply bright-line to just residential land</i>	Focuses towards main issue of high churn of residential property No lock-in effect for commercial property where lock-in effect is most distortionary	Creates difficult boundary-drawing questions for defining residential land	Recommended Targeted towards main objective and minimises lock-in effect

Main home exclusion

39. One key design issue is whether the bright-line test should apply to a person's main home.

Options	Advantages	Disadvantages	Recommendations
<i>Don't exempt main home</i>	Greater revenue gains. Less exceptions from bright-line creates a clearer more objective test.	Taxing gains on the main home is likely to have little public acceptability.	Not recommended
<i>Exempt main home</i>	Greater public acceptability. Property is less likely to have been bought with an intention of resale if it is the seller's main home.	Less revenue gains, and bright-line becomes more subjective	Recommended Consistent with existing land-sale rules

Inherited and relationship property

40. The current land sale rules provide special treatment for inherited property and relationship property. The analysis below considers whether special treatment should apply under the bright-line test for these transactions.

Inherited property

Options	Advantages	Disadvantages	Recommendations
<i>No relief</i>	Fewer exceptions from bright-line test mean rules are simpler to apply and enforce.	Bright-line would apply in circumstance where person acquired property due to an inheritance and never intended to acquire the property.	Not recommended
<i>Limited rollover relief</i>	Would align the relief with current land sale rules. Provides partial relief for persons who did not intend to acquire the property.	Only partial relief is available for close relatives, relationship partners, or charities. This means persons would be captured by the bright-line test in some circumstances even though they never intended to acquire the property.	Not recommended
<i>Limited rollover relief with subsequent exemption</i>	Means bright-line will not apply to close relatives of the deceased where they did not intend to acquire the property and only acquired due to inheritance.	Relief is only available if the person is a close relative, relationship party or charity. Other persons would be captured even though they never intended to acquire the property.	Not recommended
<i>Full rollover relief with subsequent exemption</i>	Bright-line would not apply in any circumstance where person acquired property due to an inheritance and never intended to acquire the property.	More exceptions mean rules are more complex, and difficult to enforce.	Recommended This option is more consistent with objective (b). Although more exceptions make the rules more complex, we consider it is justified in circumstances where the person not only had no intention of resale, but had no intention to even acquire the property.

Relationship property

Options	Advantages	Disadvantages	Recommendations
<i>No relief</i>	Fewer exceptions from bright-line mean rules are simpler to apply and enforce.	Bright-line test could apply in circumstances where persons did not have an intention of resale and only acquired it due to a relationship breakdown.	Not recommended
<i>Limited rollover relief</i>	Aligned with current land sale rules Provides partial relief for persons who did not have an intention of resale	Bright-line test will apply in some circumstances where relationship partner only acquired property due to relationship breakdown and did not have an intention of resale.	Recommended The relief for relationship property is narrower than that for inheritance. However for a relationship property settlement the parties have more choice

			about whether they receive the property. In addition the property was likely to have been obtained during the relationship so they will likely have intended to acquire the property
<i>Full rollover relief with subsequent exemption</i>	Bright-line test would not apply in circumstance where person only acquired property due to a relationship breakdown and did not have an intention of resale	More exceptions mean rules are more complex, and difficult to enforce.	Not recommended

Losses

41. The bright-line test creates a particular revenue risk. People can ensure that their losses are realised while any gains are. The analysis below considers the most appropriate treatment of losses under the bright-line test to address this risk.

Options	Advantages	Disadvantages	Recommendations
<i>Fully allow losses</i>	No economic distortions	Significant revenue risk as people will accelerate unrealised losses and defer unrealised gains	Not recommended Revenue risk significant
<i>Ring-fence losses arising solely under the bright-line test</i>	Reduces revenue risk Note that losses from property sales that are also taxable under the current land sale rules (ie, that are not solely taxable under the bright-line test) will not be ring-fenced, thereby mitigating any distortions.	Creates an economic distortion where people without offsettable gains will under-value risky investments	Recommended Revenue risk mitigated
<i>Revenue account declaration</i>	Reduces revenue risk	Creates potentially unfair asymmetry – taxpayers have to declare intention of resale for loss, but gains are taxed regardless of declaration Would complicate the tax system	Not recommended Revenue risk is better addressed with ring-fencing as this creates less asymmetry and potential unfairness

Land-rich companies and trusts

42. The current land sale rules can be avoided through holding property in a company or trust and transferring control of the company or trust rather than selling the land itself. The analysis below considers how best to address people avoiding the bright-line test through the use of land-rich companies and trusts.

Options	Advantages	Disadvantages	Recommendations
<i>Comprehensive rule</i>	Rules would be accurate and robust	Increased complexity and compliance costs	Not recommended Complexity does not appear to be justified as at present it does not appear there are large numbers of people avoiding the land sale rules through the use of companies or trusts.
<i>Anti-avoidance rule</i>	Less complexity and compliance costs	Less robust and creates uncertainty	Recommended Targeted towards main issue without being overly complex

Other impacts

43. There are no social, cultural, or environmental impacts associated with the broad options and the specific design options.

CONSULTATION

44. Treasury and Inland Revenue released an officials' issues paper titled *Bright-line test for sales of residential property* on 29 June 2015. A total of 14 submissions were received.

45. Three submissions supported the bright-line test and three did not support it. Submissions in favour of the bright-line test submitted that the bright-line test appeared to be a reasonable addition to the current intention test to ensure that property investors declare the income they are required to. Submitters who did not support the bright-line test to be unprincipled and likely to only apply to persons who are forced to sell property due to circumstances outside of their control.

46. One submitter proposed reducing the bright-line period to one year, and one submitter proposed extending the period to 4 to 5 years.

47. The majority of submissions focused on the design of the bright-line test. There were five main areas of concern raised by submitters. These were:

- The start date of the bright-line period
- The scope of the main home exception
- Loss ring-fencing
- The proposed land-rich company rule
- Submitters also proposed new exceptions to the bright-line

48. The majority of concerns regarding these issues was that the proposed design is not fully aligned with the current land sale rules. Submitters were concerned that the areas of departure would create greater complexity and they were typically not taxpayer friendly.

49. While officials accept that departure from existing land sale rules can cause complexity we consider that where the design of the bright-line test is not aligned with current land sale

rules it is generally to ensure the bright-line test achieves its goal of being an objective, easy to enforce rule.

50. We have made several changes to the technical detail of the proposal in response to submissions and to address complexity concerns raised by submitters. These include:

- Clarifying the time when a person's 'main home' is determined
- Clarifying the end date of the bright-line where there is no contract to sell the property
- Limiting the definition of arrangement for residential land so that it only includes arrangements which the seller is a party to
- Clarifying that bare land capable of being used for residential purposes is residential land
- Creating a new 'bright-line' rule for habitual sellers
- Enabling more trusts to use the main home exception by loosening the proposed restrictions on trusts using the main home exception
- Defining what is a land-rich company and trust
- Setting out what amount of change of ownership is required to trigger the proposed anti-avoidance rule

CONCLUSIONS AND RECOMMENDATIONS

51. Inland Revenue supports option 1. We consider that option 1 provides the best targeted option and provides easier enforcement of the land sale rules against the key problem of short term speculation in residential property. Option 1 achieves this while not covering many sales that were not bought with an intention of resale.

52. The design of the bright-line test is intended to support the objectives. The design of the bright-line is based on having clear objective rules and only a few tightly defined exceptions. This helps ensure that the bright-line is clear and unambiguous.

IMPLEMENTATION

53. Legislative change to the Income Tax Act 2007 would be required to implement either option 1 or 2.

54. Any legislative amendments required to implement option 1 or 2 could be included in a bill introduced prior to the application date of 1 October 2015.

55. Inland Revenue will be required to update forms and communication material. Inland Revenue is developing a new attachment to income tax returns to assist in implementing and reporting on the land sale rules.

56. Inland Revenue will administer the bright-line test.

MONITORING, EVALUATION AND REVIEW

57. Inland Revenue is putting in place new systems for administering the bright-line test including a new form to monitor property sales subject to the bright-line test. In addition, as noted above, as part of Budget 2015 further measures are being introduced to provide more useful information to Inland Revenue about land sales. These measures will enable Inland

Revenue to have better information about the level of compliance with the land sale rules and the revenue generated by the bright-line test.

58. If any detailed concerns are raised in relation to these changes, Inland Revenue will determine whether there are substantive grounds for review under the Generic Tax Policy Process.

This regulatory impact statement incorporates minor typographical changes made after it was submitted to Cabinet. This includes:

- Adding page numbers
- Correcting option number cross-references.