Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Tax Working Group recommendations: Family home and second homes

Date:	17 January 2019	**Priority:**	Medium
Security level:	SENSITIVE	**Report number:**	IR2019/014; T2019/035

Action sought

	Action sought	Deadline
Minister of Finance	**Discuss** with officials	N/A
Minister of Revenue	**Discuss** with officials	N/A

Contact for telephone discussion (if required)

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17 January 2019

Minister of Finance
Minister of Revenue

Tax Working Group recommendations: Family home and second homes

Executive summary

1. You have asked for advice on:

   - Whether the existing main home exclusion in the bright-line test can be adapted for the purposes of the proposed extension of tax on capital gains, and
   - Whether second homes such as baches should be exempt.

2. This report provides some initial advice on these issues and recommends you discuss this advice with your officials.

Main home definition

3. We consider that the proposed family home exclusion in the context of extending capital gains taxation should be generally based on the existing bright-line main home exclusion. However, we consider that there are some reasons to depart from the definition in the existing bright-line rules. These reasons include:

   - Some aspects of the existing rules could be improved, whether or not there is an extension of the taxation of capital gains. CA ANZ has previously raised potential concerns with the current bright-line rules. We intend to informally consult with CA ANZ to better understand what those issues are.
   - The longer-term nature of taxing more capital gains may require taking a different approach compared to the 5 year bright-line test.
   - Significantly more taxpayers will need to consider whether they fall under the exemption under the proposed new tax rules than was the case under the bright-line rules, which in our view suggests that, in designing the new exemption, simplicity and clarity should be given greater weight.
   - The existing bright-line rules apply only to residential land. If the extension to capital gains includes farmland, additional rules will need to be developed to ensure that the rules cater for owner-occupied farm houses and lifestyle blocks.

4. The TWG is finalising its report to you which includes its proposal for a definition of the excluded home. There are some aspects of their conclusions on the excluded home definition that we are likely to disagree with.

5. We plan to report back in late January and early February on our advice on the TWG recommendations, which will include more detailed advice and options for the proposed main home exclusion rules. We will also advise on whether any of these options are likely to affect the fiscal costs.

Second homes

6. This report also discusses the TWG’s proposal to tax second homes, including holiday homes. The TWG proposed taxing second homes in order to enhance fairness and efficiency. Taxing second homes also avoids boundary issues between rental properties which could occur if second homes were exempt but rental properties are taxed (given that many holiday homes are rented out for short periods). It would also be difficult to identify holiday homes separately from second homes.

7. The fiscal cost of exempting second homes would be $430m over the first five years. These fiscal costs are indicative and subject to further quality assurance.

Recommended action

8. We recommend you:

a) note the contents of this report.

Noted Noted

b) discuss the contents of this report with officials.

Discussion needed/No discussion Discussion needed/No discussion

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Hon Grant Robertson
Minister of Finance
/ /2019

Hon Stuart Nash
Minister of Revenue
/ /2019

Background

9. The Government has committed to excluding the family home from any potential extension of capital gains taxation.

10. Twenty-six submissions were received on the TWG's interim report in relation to the exclusion for the family home. These submissions were largely in favour of having an exemption.

11. An advantage of having a family home exclusion is that, for the majority of taxpayers, it should reduce compliance costs that would otherwise be imposed from taxing more capital gains.

12. Statistics New Zealand estimates suggest that there are 1.88 million dwellings in New Zealand, and of those 1.17 million (62%) are owner-occupied. We expect that the majority of owner-occupied homes are likely to be clearly eligible for the family home exclusion – that is, they should easily be able to be self-assessed as being an excluded home upon disposal. Other properties will clearly not be eligible (e.g. residential rental property owned by an investor).

13. However, a smaller group of home-owners who have more complex situations (e.g. more than one home, a change of use of their home, or where there is mixed use of their home) will need to consider whether the excluded home provision applies to their situation. In designing the rules, judgement calls will need to be made on whether (or to what extent) it is appropriate for the exclusion to apply in these cases.

Family home definition

14. Key issues with the definition of an excluded home that will need to be decided are:

- Who is eligible for the exclusion (i.e. individuals, trusts and other ownership structures)?
- What is a main home?
- If a person has more than one home, which home is eligible?
- What happens when a person uses the home for multiple purposes - i.e. the property is used both for income earning purposes as well as the person's home?
- What happens if there is a change of use - i.e. if the property stops being used as a person's home during the period of ownership?
- How much land surrounding the house is eligible for the exclusion? This is particularly relevant for farms and lifestyle properties.
- Whether there should be a value cap.

15. There are existing concepts of an "excluded home" in two areas of the Income Tax Act:

- the bright-line test and
- the provisions that tax land sales for taxpayers holding land on revenue account (e.g. dealers and developers, and taxpayers who acquire land with the intention of resale).

16. These definitions are broadly similar but differ in detail from each other.

17. Overseas jurisdictions (including Australia) also generally exclude the main home from taxation, and again there are slightly different approaches used in different countries.

18. In our view, the best approach will balance the following factors in an optimal way. The exclusion should:

- be widely viewed as fair and acceptable by most taxpayers;
- have minimal compliance costs for as many home-owners as possible;
- minimise distortions to the extent possible, including distortions affecting how people invest spare capital and how they use their homes;
- minimise the opportunity for abuse; and
- be relatively consistent with overseas models - especially Australia, and any countries that we consider have a best practice capital gains tax.

19. We consider that the proposed family home exclusion in the context of extending capital gains taxation should be generally based on the existing bright-line main home exclusion. We note that the bright-line rules have been in place since 2015. The tax community is now beginning to be familiar with the existing concepts used for the bright-line rules and there has been guidance published by Inland Revenue. As such, we think the existing concepts should be used unless the proposed concepts are clearly better, because this approach is likely to lower compliance costs during the transition period.

20. Some areas where we consider that there are compelling reasons to depart from the definition in the existing bright-line rules are as follows.

21. First, some aspects of the existing rules could be improved. CA ANZ has previously raised potential issues with the current bright-line rules. We intend to informally consult with CA ANZ to better understand what those issues are.

22. Second, there may be a case to depart from aspects of the bright-line rules because the longer-term nature of taxing more capital gains may require taking a different approach compared to the 5 year bright-line test. For example, a home can be exempt under the bright-line test as long as it was the person's main home for the majority of the period of ownership. This might not be an appropriate measure over a longer holding period. If the bright-line test was adopted for the new rules, a person that owned and occupied a property for 10 years and then rented it out for 9 years would be able to claim the exemption for the full period of their ownership. This may not be an appropriate result.

23. Further, significantly more taxpayers will need to consider whether they fall under the exemption under the proposed new tax rules than was the case under the bright-line rules, which in our view suggests that, in designing the new exemption, simplicity and clarity should be given greater weight.

24. Finally, the existing bright-line rules apply only to residential land. If the extension to capital gains includes farmland, additional rules will need to be developed to ensure that the rules cater for owner-occupied farm houses and lifestyle blocks.

25. The TWG is finalising its report to you which includes its proposal for a definition of the excluded home. There are some aspects of their conclusions on the excluded home definition that we are likely to disagree with. We will report back to you in more depth alongside the Group's final report to highlight these areas of difference (along with our views on other TWG recommendations).

Excluding a taxpayer's second home

26. Some submitters to the TWG considered that second homes, including holiday homes, should be exempt. An argument from some of those submitters was that second homes are personal use assets in the same way that owner-occupied housing is, rather than income-producing assets.

27. We consider that there are several reasons for not excluding the second home.

28. One of the reasons for taxing second homes is to improve fairness, so that taxpayers who own wealth in different ways are taxed in a similar way.

29. Another reason for taxing second homes is that they are likely to have time periods where they are not occupied, so there is no efficiency or housing-related reason to exempt them.

30. A further concern is boundary issues between rental properties and second homes. Second homes are often rented out for short periods, so taxing gains from rental properties but not second homes creates boundary issues that could be difficult to address.

31. Finally, we note that second homes are not exempt under the bright-line rule.

Fiscal costs

32. As reported to the Minister of Finance on 11 January, the fiscal cost of exempting second homes is $430 million over the first five years[1]. These fiscal costs are indicative and subject to further quality assurance. Officials had previously estimated $200 million over this period. The reason for revision is that further analysis of Household Economic Survey (HES) data shows that only a subset of second homes were included. Further analysis shows that there is a bigger range of second homes which we have now included.

Next steps

33. We recommend you discuss the contents of this report with officials.

34. We plan to report back in late January and early February on our advice on the TWG recommendations, which will include more detailed advice and options for the proposed main home exclusion rules. We will also advise on whether any of these options are likely to affect the fiscal costs.

35. The development of the family home definition would be subject to the normal generic tax policy process, including a discussion document in the middle of this year. Upon implementation, Inland Revenue would also ensure that that guidance for taxpayers (with examples) would be published.

[1] We have assumed the same turnover rate for second homes as for all residential property. While the turnover rate may be different for different types of residential properties, we do not have sufficient data to assess this.