Inland Revenue
Te Tari Taake

TE TAI ŌHANGA
THE TREASURY

Briefing note

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Subject: **Taxing residential property - Main home plus one exclusion rule**

Purpose

This briefing note provides you with details of the costings and policy considerations for a proposal to have a main home plus one exclusion rule for the extension of the taxation of capital gains to residential property.

This note has been prepared in haste, officials have not had the opportunity to consider this proposal in any depth. This note outlines a number of key policy issues we have identified. Some of these are complex. We are not confident that we can advise Ministers on all of the considerations and potential implications of this proposal in time for an April announcement.

Summary of general design details

We understand that the proposal is to allow each person to have one main home, and one other property that is excluded from the extension of the taxation of residential property. This section outlines some of the key features that would need to be considered in such a design:

- The restriction to one main home will mean that, where two or more people share one main home, that one property will be the main home of all of those people.
- It will be necessary to consider whether all individuals will be able to have a main home, plus one other property, or whether this should be limited to individuals over the age of 18. This will affect the costings for this proposal because those with multiple rental properties may hold them in their children's name to get

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additional exemptions. The more people who are able to have an excluded home, the less tax is likely to be collected from any extension of the taxation of residential property.

- It will be necessary to consider whether entities other than individuals can own an excluded property. Many properties in New Zealand are owned through a trust or company structure. A trust can hold multiple properties for multiple beneficiaries. A company can also be owned by a number of people. Rules around the types of structures that can be used to hold excluded properties could become quite complex. Depending on the design, this could also have a significant impact on the tax that is likely to be collected from any extension of the taxation of residential property.

- There will need to be rules around the disposal and acquisition of excluded properties to determine, where a person has more than two properties that could be excluded, which properties are the excluded properties. These rules could become quite complex, and lead to complex structuring. Depending on the nature of these design decisions this may have significant impact on the tax that is likely to be collected from any extension of the taxation of residential property (see Appendix One for an example of how this may work in practice).

- If it is decided to have an exclusion for a second property, we would recommend that the bright-line test is retained, so that if the second property is sold within 5 years, it would be taxed.

We consider that there is a significant risk of people structuring so that they only ever own excluded properties (either by transferring properties to associates, or by exiting the market altogether). Where people do not only own excluded properties, we consider that there is a risk that people will seek to have valuations that are favourable to them.

Both administrative and compliance costs would be higher under this proposal than under the status quo, and under a proposal for only the main home to be excluded.

If the intention of allowing two excluded properties per individual is to ensure that existing investment properties are not taxed, officials consider that taxing all residential property (excluding the main home), but on a grand-parented basis, would be a better option. This would mean that only properties purchased after the introduction of the new tax would be taxed. However, this option is likely to result in no additional revenue for the first five years.

Fairness and efficiency

The rules outlined above will significantly affect the fairness and efficiency of the tax extension.

By exempting more properties, the horizontal equity benefits of the tax are reduced. Because the exemption is related to numbers of properties rather than value or income, the fairness implications will tend to be arbitrary. As an example, a property worth $400,000 will qualify for the exemption, as will a $2m property. These two properties will likely end up producing very different amounts of exempt capital gains income.

In officials' view, the efficiency impacts will make the rule described above worse than the status quo. The rule will have higher administration and compliance costs than the status quo or a broader extension that exempted only the main home. The rule will encourage small scale ownership over professional landlords. These compliance, administration, and distortionary ownership costs are likely to be high when compared to the revenue raised. In addition, the exemption that favours small scale is likely to increase rents more than just having a main home exemption, because of the reduced competition from larger-scale landlords.

Costings

Revenue estimate for taxing residential property

Table 1 below provides the estimated revenue from taxing capital gains from residential property where individuals get the family home excluded as well as one additional residential property.

Estimated revenue $b	*2021/22*	*2022/23*	*2023/24*	*2024/25*	*2025/26*	*Total over five years*
Revenue from taxing capital gains from residential property where individuals have family home exempted and an additional residential property	0.01	0.05	0.13	0.21	0.30	0.7

There is a high degree of uncertainty with this revenue estimate. The estimate relies on behavioural assumptions, and assumptions regarding the design of the exemption. In addition there are data limitations that mean it is uncertain how many residential properties each New Zealander owns. These are considered further below.

Design decisions assumed in revenue estimate

The assumed design of the exemption heavily affect this revenue estimate. This revenue estimate is on the basis that the exemption follows the following design:

- ***Election of exemption:*** People elect which property is exempt prospectively (i.e. on purchase, valuation day, or when previously exempt property is sold)
- ***Valuation day for new exemptions:*** When an exempt property is sold, any new property that is elected for an exemption only has gains made after the election date exempted from the capital gains tax
- ***Bright-line test:*** The five-year bright-line test continues to apply. This means that the additional property exemption does not apply to property sold within five years of acquisition
- ***Companies, trusts and minors:*** There are strict rules to prevent people obtaining the exemption multiple times through companies, trusts and their children.

The revenue could be significantly less, and potentially nil (or negative if the bright-line is repealed) if there is a different design.

Assumptions used for costing

The costing incorporates a behavioural assumption that every existing landlord effectively gets two rental properties exempted in addition to their main home. This additional exemption is because we assume that most landlords will transfer rental properties to associates (such as their partner) who do not currently own a rental property to obtain the exemption. This results in 63% of rental properties being exempted[1].

We have assumed that all second homes are exempted under this proposal. This is on the basis that it would be relatively simple for most owners of second homes to transfer property to an associate to obtain the benefit of the exemption and it is unlikely that people will own multiple additional homes.

[1] Based on analysis of MBIE data on the number of properties held by each landlord.

There are other potential behavioural changes that could also affect the revenue that are not incorporated in this costing. For example, the costing does not incorporate how taxpayers may choose the property most likely to earn capital gains as their exempt property and does not incorporate the ownership of rental property likely being increasingly owned by smaller landlords.

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Appendix One – Example

Tom and Samantha own five rental properties, a bach, and a family home on valuation day.

On valuation day, they nominate two of their five rental properties to be exempt properties. They do not nominate the bach to be exempt because they do not intend to sell it, so the exemption is of little value.

They can nominate two rental properties instead of one, because there are two of them and the income tax system operates on an individual basis.

After 6 years Tom and Samantha sell one of their exempt properties. This property is legally owned by Tom, and no tax on the gain is paid. At that point, Tom is not using one of his exempt property entitlements, and so he nominates one of their remaining three non-exempt properties to now become exempt.

Because that property was not exempt for the first six years after valuation day, a new valuation is required to ensure that when this now-exempt property is sold, tax is paid on the gain for those six years[2]. The property had increased in value from $500 000 to $600 000 during those six years. As a consequence, when that property is eventually sold, tax of $33 000 (assuming a 33% tax rate) will be paid.

After a further four years, Samantha sells her exempt property, and the couple buy another property. Samantha elects for this property to be her additional exempt property.

[2] Without this rule no tax would ever be paid under this regime.