Taxation (Annual Rates for 2020–21, Feasibility Expenditure, and Remedial Matters) Bill

Supplementary Order Paper No 23

Regulatory Impact Assessments

Prepared by Policy and Regulatory Stewardship, Inland Revenue

March 2021

Regulatory Impact Statement: COVID-19: Tax relief for donations of trading stock

Coversheet

Purpose	
Decision Sought:	Introduce a temporary exclusion to the deemed income rule that applies to donated trading stock
Advising Agencies:	Inland Revenue
Proposing Ministers:	Minister of Revenue
Date:	18 January 2021

Problem Definition

Businesses are currently disincentivised from donating trading stock during COVID-19 (and more generally) due to an integrity rule in the Income Tax Act 2007 which deems a donation of trading stock to be a sale at market value.

Executive Summary

A deemed income rule in the Income Tax Act 2007 disincentivises businesses from donating trading stock during COVID-19 by imposing tax on the market value of the donated trading stock. This effectively reverses the deduction that was claimed when the trading stock was purchased and imposes tax on a deemed profit.

> Example – deemed income rule
>
> A supermarket donated canned food to a food bank which was purchased for $500 and had a market value of $750. Under the deemed income rule the supermarket would need to pay $70 of tax ($250 x 0.28, 28% being the company tax rate) on that donation despite also being out of pocket for the value of the canned food.

This rule was introduced as an anti-avoidance measure (for example, it prevents a person from donating trading stock to an associate to avoid the income tax that would otherwise be payable on the sale) but is over-reaching by imposing tax in situations where tax avoidance is not a concern.

Officials recommend turning off the deemed income rule in certain circumstances for donations of trading stock made on or after 17 March 2020 and before 17 March 2022, as a COVID-19 response measure.

The proposed amendment will provide that trading stock donated to:

(i) public authorities and donee organisations (the latter being organisations whose donors can claim a tax concession for donations made to the organisation) will not be subject to the deemed income rule and will be eligible for a tax deduction for the cost of the donated trading stock.

(ii) non-associated persons (that are not public authorities or donee organisations) will not be subject to the deemed income rule. However, the donor will only be able to claim a tax deduction for the cost of the donated trading stock where they can demonstrate the donation is made for business purposes.

This option will temporarily remove the disincentive to donate trading stock. It has an estimated fiscal cost of $10 million over two years.

The proposal has been consulted on and stakeholders are supportive of it, although they would also like a permanent solution.

Limitations or Constraints on Analysis

Timeline

Changes to the tax rules for donated trading stock need to be made by 31 March 2021 so that COVID-19 related donations made in the 2019-20 income year (i.e. between 17 and 31 March 2020) can be treated appropriately. This timeline has limited the options that officials could consider and the analysis of those options.

Data

Data related to fiscal cost estimates: Inland Revenue has no data on trading stock donations. Therefore, the estimated fiscal cost is based on several assumptions, such as using data on cash donations as a proxy for donations of trading stock.

Data related to effectiveness of the measure: Inland Revenue is unable to quantify the extent to which donations of trading stock would increase under the proposed measure and can rely only on anecdotal evidence from stakeholders.

Responsible Manager

Stewart Donaldson
Principal Policy Advisor

Policy & Strategy
Inland Revenue

18 January 2021

Quality Assurance

Reviewing Agency/Agencies:	Inland Revenue

Panel Assessment & Comment:	The Quality Assurance reviewer at Inland Revenue has reviewed *the COVID-19: Tax relief for donations of trading stock* RIA and considers that the information and analysis summarised in it **meets** the quality assurance criteria of the Regulatory Impact Analysis framework.

Section 1: Outlining the problem

Context/Background Information

The tax rules for donated trading stock disincentivise businesses donating goods during COVID-19

Since the COVID-19 pandemic began in New Zealand in March 2020, anecdotal evidence suggests that the amount of goods donated by businesses has increased.

Stakeholders have informed both officials and the Minister of Revenue's office that the Income Tax Act 2007 is disincentivising businesses from donating goods during COVID-19 by imposing tax on the market value of donated trading stock. For businesses that have already donated, but not yet filed a tax return, the tax treatment should be amended.

Stakeholders have requested that legislation resolving the issue be enacted "as soon as possible" as taxpayers will need to take positions in respect of the 2019-20 income year by 31 March 2021. They have also requested that work begins on a permanent solution.

Current law

Gift deductions are limited to gifts of money to donee organisations up to the level of the donor's income

Tax credits and deductions for donations are limited to gifts of money made to donee organisations, up to the level of the person or company's taxable income.

Tax concessions are not available for donations in kind due to the potential avoidance opportunities that would be created where there is no easily verifiable market value.

The deemed income rule imposes tax on the market value of donated trading stock

Trading stock is generally deductible in the income year it is purchased as a business expense. If it is not sold in the year of purchase, closing stock is included as income at the end of the year and then becomes deductible as opening stock the following year.

A deemed income rule applies when a person disposes of trading stock for less than market value, including when trading stock is donated for charitable purposes. The rule deems the market value of donated trading stock to be assessable income. This means businesses are effectively taxed on a deemed profit margin for the donated goods, (i.e., the difference between the deemed market value and the deduction obtained on purchase or in the opening stock adjustment).

Policy intent

The deemed income rule was introduced as an anti-avoidance measure intended to apply to non-arm's length transactions, but is drafted broadly and applies to all transactions

The deemed income rule was introduced in the late 1940s as an anti-avoidance measure. It was intended to combat situations such as where of a retiring farmer gifted stock to a relative who was also a farmer. Income tax was avoided by the retiring farmer on the gift. However, the succeeding farming business could revalue the stock brought onto its books at market value (even though it had paid nothing, or a nominal amount, for the trading stock). Another example of avoidance caught by the rule is where a business donates trading stock to an associate to avoid the tax that would otherwise be payable, but there is a linked transaction to ensure the business receives market value in return.

The provision was intended to treat the stock in the same way as if it were sold. It was not intended to apply to genuine arm's length transactions even where there appears to be inadequate consideration. However, the provision was drafted broadly, and still is today, so that it also applies to arm's length transactions.

Previous relevant decisions

There is precedent for turning off the deemed income rule in response to adverse events

A permanent provision allows relief from the rule when trading stock is donated to a person not associated with the donor for the use in a farming, agricultural or fishing business that is affected by a self-assessed adverse event.

An 18-month exclusion from the rule was introduced in response to the Canterbury earthquakes. This exclusion applied when trading stock was donated to a person not associated with the donor for the purpose of relief from the adverse effects of the earthquakes.

The previous Minister of Revenue agreed to progressing an amendment after the 2020 election and sent a letter to stakeholders to this effect.

What is the policy problem or opportunity?

Problem definition

The deemed income rule, an anti-avoidance provision, is imposing tax where tax avoidance is not a concern and disincentivising donations of trading stock during COVID-19

The deemed income rule was introduced to counter tax avoidance, however its application results in an over-reach that impacts on the fairness and equity of the tax system. In particular, the provision imposes tax where tax avoidance is not a concern. In the situation where trading stock is donated, the provision can act as a significant disincentive because it imposes tax on a deemed profit on the donor of the goods. For example, it will impose tax on goods donated during COVID-19 for public benefit, such as food donated to food banks or masks and medical equipment donated to hospitals. The rule is generally perceived to be unfair and as a result compliance with this rule is very low.

Currently some businesses incur compliance costs to structure around the deemed income rule – for example by entering into sponsorship arrangements with donees to formalise the value exchange (i.e., if the business is getting something of equal value for their donation then the deemed income rule does not apply).

How is the status quo expected to develop if no action is taken?

If no action is taken the deemed income rule will continue to disincentivise compliant businesses from donating trading stock.

What is the nature, scope, and scale of the loss or harm being experienced?

The rule imposes tax on a profit a business has not made, to be paid from funds it may not have as it has not sold the goods. Officials do not have any evidence relating to the scale of the loss being experienced, other than anecdotal evidence from stakeholders. The amount of loss will depend on the value of the donation, this is best illustrated through an example.

Example

Suppose a supermarket buys a supply of hand sanitiser for $10,000, which is normally sold in the store for $15,000. If the business donates that hand sanitiser to the local hospital, they will need to pay $1,400 of tax ($5,000 x 0.28) despite receiving no income. The donation has therefore cost the supermarket a total of $11,400. Donating the same amount in cash ($10,000) would have cost it $7,200 after allowing a $2,800 gift deduction. In addition, the supermarket would have to fund the amount of tax to pay as no funds arise from the donation.

Who are the stakeholders in this issue, what is the nature of their interest, and how are they affected?

Both donors and donees are affected:

- **Donors:** Any business that donates trading stock is affected as tax is imposed on a deemed profit – an amount the business has not received. This increases the cost of the donation to the business.

- **Donees:** Any charity/person that receives donated trading stock is also affected. Officials spoke to Auckland City Mission staff and advisors who mentioned that the deemed income rule encourages businesses to donate obsolescent stock as the market value of this would be zero or close to zero, and thus no/little adjustment would be required. Auckland City Mission's policy is to take all donations, even if near expiry, but noted that receiving food close to expiry is problematic for them as they need to distribute it immediately or it is wasted. They want the tax system to encourage the donation of good quality food, rather than discourage it. Removing the disincentive should achieve this.

What are the key assumptions underlying this policy problem?

There is a high level of non-compliance with the rule. For those that would comply with the rule, it is disincentivising donations of trading stock. Not all businesses that donate trading stock would be prepared to donate cash instead.

What objectives are you seeking in relation to this policy problem or opportunity?

There are two objectives:

- **Objective one:** remove a tax impediment to donating trading stock, particularly during COVID-19 where there is an increased need in the community.

- **Objective two:** ensure the provision is robust and there are limited opportunities for tax avoidance.

There are trade-offs between these two objectives (i.e., the more relief that is provided from the deemed income rule the greater the removal of the disincentive to donate, but more tax avoidance opportunities may arise).

Section 2: Option identification and impact analysis

What criteria will be used to evaluate options against the status quo?

The options will be assessed against the objectives previously mentioned, as well as the criteria of fiscal cost and fairness.

What scope are you considering options within?

The status quo is a less viable option as the previous Minister of Revenue wrote to a select group of stakeholders committing to a temporary solution.

Because legislation needs to be enacted by 31 March 2021 to ensure that donations made between 17 and 31 March 2020 are treated appropriately, there was not sufficient time to consider a permanent solution to the deemed income rule. Targeted consultation to date has shown that stakeholders hold differing views on the best approach to a permanent solution, so any permanent change would warrant wider public consultation as part of the Generic Tax Policy Process. Officials propose beginning work on a permanent solution, subject to prioritisation on the tax policy work programme.

Describe and analyse the options

Option one – status quo

The current law – tax must be returned on a deemed profit for any donations of trading stock. However, if the status quo is not amended, the unfairness and disincentive to donate will continue to exist.

Option two (preferred) – targeted temporary exclusion from the deemed income rule

An exclusion from the deemed income rule (with the ability to modify the application period by Order in Council) for donations of trading stock made on or after 17 March 2020 and before 17 March 2022.

The proposed amendment will provide that trading stock donated to:

(i) public authorities and donee organisations will not be subject to the deemed income rule and will be eligible for a tax deduction for the cost of the donated trading stock.

(ii) non-associated persons (which are not public authorities or donee organisations) will not be subject to the deemed income rule. However, the donor will only be able to claim a tax deduction for the cost of the donated trading stock where they can demonstrate the donation is made for business purposes.

Option three – more limited temporary exclusion from the deemed income rule

Same as option 2 above, except a deduction for the cost of the donated trading stock would not be allowed where the donation was made for a business purpose (i.e., the deemed income rule would be turned off, but the deduction would be added back, effectively only turning off the deemed profit aspect of the rule).

Key features of option two (the preferred option)

Donations to public authorities and donee organisations:

- This allows the business a deduction for the cost of the donated trading stock with no corresponding income arising.
- This would ensure 'gifts' of trading stock qualify for a tax deduction in a similar way to a gift of money, with the exception that the deduction is not limited to the net income of the donor. The limitation to net income has not been proposed on the basis that many donating businesses may be in loss as a result of COVID-19, so any such limitation would cause the amendment to be of limited benefit.
- This includes donations to associated parties that are donee organisation or public authorities (i.e., a business that donates something to its own donee organisation). Donee organisations and public authorities are subject to regulation and are publicly transparent so there are no specific integrity concerns even where the parties are associated.
- This approach is broadly consistent with the government's donations framework where donations of money to donee organisations are eligible for a deduction.
- Unlike the policy solution implemented in response to the Canterbury earthquakes, there is no requirement that the donations must be made specifically to people or organisations who have suffered as a result of COVID-19. The rationale is that it could be argued that almost everyone in NZ suffered as a result of COVID-19. To minimise the risk of abuse, the concession is restricted to donee organisations and public authorities.

Donations made to non-associates:

For a business purpose:

- This allows the business a deduction for the cost of the donated trading stock with no corresponding income arising.
- Because the donation has been made to promote the taxpayer's business (i.e., increased customer loyalty/brand awareness, even if there is a charitable element to it), the deduction should not be reversed by the deemed income rule.

Not for a business purpose:

- This ensures the business does not have to pay tax on a deemed profit.
- This applies to pure gifts made by business where there is no material benefit or advantage to the donor.
- This ensures there is identical treatment to a business donating money to an organisation that is not a donee organisation or public authority. For example, if a

business donates either food or money directly to an individual person (not to a donee organisation) they receive no tax deduction, and they do not have to pay tax on a deemed profit on the donated food.

Analysis of options against objectives

Option one - status quo

Objective one – removing the tax impediment to donating trading stock

This option does not achieve this objective as businesses are required to pay tax on a deemed profit when donating trading stock which creates the tax impediment.

Objective two – ensure the provision is robust and avoidance opportunities are minimised

This objective is achieved at the expense of also capturing genuine donations of trading stock that are not a concern.

Option two – targeted temporary exemption from the deemed income rule (preferred option)

Objective one – removing the tax impediment to donating trading stock

This option achieves this objective as a business will no longer have to pay tax on an assumed profit when donating trading stock on or after 17 March 2020 and before 17 March 2022 (unless the donation is to an associated party that is not a donee organisation or public authority in which case the deemed income rule is appropriate to prevent tax avoidance).

Objective two – ensure the provision is robust and avoidance opportunities are minimised

Avoidance opportunities are limited since relief from the deemed income rule is only provided when:

- Donations are made to donee organisations and public authorities. These organisations are subject to regulation and are publicly transparent.
- Donations are made for a business purpose to non-associates that are not donee organisations or public authorities. There is likely to be minimal mischief in these cases as the donation results from a commercial decision to receive a benefit or advantage such as enhancing the business's brand. The fact the donation must be made to a non-associate reduces the chance of any artificial transaction. Existing tax rules – such as the deemed dividend rules, fringe benefit tax, and the general anti-avoidance rule, also limit the scope for abuse.
- Donations are made for a non-business (charitable) purpose to non-associates that are not donee organisations or public authorities. There is likely to be minimal mischief in these cases as the donation is made to a non-associated entity. The proposed amendment does not allow a deduction in these situations, it simply removes the requirement to report the market value as deemed income, so the risk to the tax base is minimal.

What is the level of stakeholder support for this option?

Stakeholders fully support this option although they prefer a permanent solution.

Will there be an increase or decrease in the benefit to society compared with the status quo?

Because there is a high level of non-compliance with the deemed income rule, the change will mainly align the law with commercial practice. At the margins there should be some increase in donations of trading stock (and the quality of those donations) which will have a social benefit, but will also result in slightly less tax collected.

Option three –more limited temporary exemption from the deemed income rule

Objective one – removing the tax impediment to donating trading stock

This option achieves this objective but to a lesser extent than option two, as a business donating trading stock for a business purpose will be disallowed a deduction under this option.

Objective two – ensure the provision is robust and avoidance opportunities are minimised

Avoidance opportunities are limited – same rationale as option two.

What is the level of stakeholder support for this option?

Stakeholders prefer this option to the status quo as it would remove the deemed income arising on the donation of trading stock but believe it does not go far enough. In particular, they do not think it appropriate to disallow a deduction for the cost of the donated trading stock where trading stock is donated for a business purpose. It is not uncommon for businesses to donate trading stock as a way of promoting their business (i.e., increased customer loyalty and brand awareness, even if there is a philanthropic element to it). This is currently deductible under general tax rules and this option would reverse that position. The proposal to not permit a deduction for the cost of the donated trading stock should only apply where there is no business reason for making the donation – such as pure gifts where there is no material benefit or advantage to the donor. Donating trading stock for a commercial outcome is a genuine business expense and should be treated as such.

Will there be an increase or decrease in the benefit to society compared with the status quo?

Same as option two – but slightly less of an increase in donations given this option is less generous.

Multi-Criteria Analysis

	Option One – Status Quo / Counterfactual	Option Two – targeted temporary exemption from the deemed income rule	Option three – more limited temporary exemption from

			the deemed income rule
Fiscal cost	0	Cost of $10 million over two years	Similar to option two, but slightly less given the option is not as generous.
Fairness	The status quo is unfair as a business is required to pay tax when donating trading stock in circumstances where there is no concern. Tax is normally payable on profit – not when giving something away for free. If a business donated cash it would receive a tax concession in certain circumstances, but if it donates trading stock it must pay tax on a profit that has not eventuated.	Removes the disincentive to donate trading stock and ensures that trading stock that has already been donated on or after March 17 2020 is treated appropriately.	Same as option two, although the disincentive still exists to some extent where the donation is made for a business purpose to an organisation that is not a donee organisation or public authority.
Overall assessment	0	Cost of 10 million over two years. Improved fairness	Cost of this option is similar, but slightly less than option two. Improved fairness, but not to the same extent as option two.

Conclusions

Option 2 is the preferred option as it reduces the disincentive to donate trading stock whilst still ensuring that tax avoidance opportunities are limited.

Summarise the costs and benefits of your preferred option

Affected groups *(identify)*	**Comment**: nature of cost or benefit (e.g. ongoing, one-off), evidence and assumption (e.g. compliance rates), risks	**Impact** *$m present value where appropriate, for monetised impacts;*

		high, medium or low for non-monetised impacts
Additional costs of the preferred option compared to taking no action		
Regulated groups	No costs on businesses as a result of the proposed approach.	
Regulators	There is not expected to be any significant administration costs for Inland Revenue	Very low
Wider government	Fiscal cost in the form of reduced revenue in the future. Small risk of additional tax avoidance. Unlikely as: -The rule has been designed in a way to prevent abuse as mentioned previously. -Commercial considerations and existing tax rules (dividend rules, fringe benefit tax and the anti-avoidance rule) are likely to prevent abuse anyway. -There is no evidence of tax avoidance occurring when an amendment was made to the rule in response to the Canterbury earthquakes. Most donations are motivated by benevolence or brand awareness, not tax avoidance.	$10 million over a 2-year period. This estimate is based on limited data and is approximate only. Anecdotal evidence from stakeholders suggests significant non-compliance with the deemed income rule. Therefore, the proposed amendment may just align the law with commercial practice, rather than have a negative fiscal effect.
Other groups	N/A	
Total monetised costs	Fiscal cost	$10m over 2 years
Non-monetised costs	Tax avoidance risk	*Very low/nil*
Additional benefits of the preferred option compared to taking no action		
Regulated groups	Compliance costs for businesses will reduce as a result of the proposed approach. Currently some businesses incur compliance costs to structure around the deemed income rule.	Decrease in compliance costs – unable to quantify

Regulators		
Other groups (e.g., wider government, consumers etc.)	Donees are likely to see an increase in donations of trading stock as a result of the proposed option as well as an increase in quality (i.e. less obsolescent stock).	Increase in donations (and quality of those donations) – unable to quantify.
Total monetised benefits		Increase
Non-monetised benefits		Increase

Section 3: Implementing the preferred option

How will it be implemented?

If approved by Cabinet, an amendment will be included as a Supplementary Order Paper to the Taxation (Annual Rates for 2020-21, Feasibility Expenditure, and Remedial Matters) Bill.

The changes will apply for donations of trading stock made on or after 17 March 2020 and before 17 March 2022.

Inland Revenue will be responsible for administering the changes.

The public will be notified of the changes through the Tax Information Bulletin, which will be published on the Inland Revenue website once the legislation is enacted.

Monitoring, Evaluation, and Review

Inland Revenue will monitor the outcomes pursuant to the Generic Tax Policy Process ("GTTP") to confirm that they match the policy objectives. The GTPP is a multi-stage policy process that has been used to design tax policy in New Zealand since 1995.

Policy officials are exploring the possibility of surveying stakeholders (such as Chartered Accountants Australia and New Zealand) post-implementation to establish the impact of this temporary change. This will inform options regarding the development of longer-term and more enduring solution to the tax treatment of donated trading stock.

Supplementary Analysis Report: Loosening the loss continuity rules

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Supplementary Analysis Report (SAR), except as otherwise explicitly indicated. This SAR explains the policy rationale and development behind the proposal to loosen the loss continuity rules to be included in the *Taxation (Annual Rates for 2020-21 Feasibility Expenditure and Remedial Matters) Bill*. It has been produced to improve transparency and understanding of the policy as the amendments go through the legislative process. Making changes to the loss continuity rules was recommended by the Tax Working Group in its final report, *"Future of Tax"*.[1] As a result the project has been on the tax policy work programme since 2019. In September 2019, the Government announced it would consult on options to loosen the loss continuity rules in order to promote growth and innovation of start-ups and small-medium enterprises as a productivity enhancing policy. A discussion document – *Tax Losses: loss continuity and R&D related provisions* – was approved for public release by the Government on 18 March 2020. However, on 15 April 2020, the Government announced that it would accelerate this work in response to the economic impacts of COVID-19 and introduce a business continuity test after consulting on the detailed design, with retrospective application from the 2020-21 income year. The discussion document functioned as an interim RIA when it was considered by Cabinet and a final RIA was not prepared due to the short timeframe for developing policy in response to COVID-19.

Key Limitations or Constraints on Analysis
The announcement on 15 April 2020 that the Government would introduce a business continuity test modelled on Australia's rules with retrospective application to the 2020-21 year is a limitation on the analysis. Taxpayers who raise capital during the COVID-19 economic downturn have been able to take comfort from the proposed introduction of a test that would assess the continuation of their underlying business and that would leave them no worse off than the full Australian test. This limited any further analysis on the other options and focused policy development on how to adapt the Australian business continuity test for the New Zealand context.

[1] Tax Working Group (2019) *Future of Tax*. Retrieved from: https://taxworkinggroup.govt.nz/resources/future-tax-final-report-vol-i

In order to enact new loss continuity rules by the end of the 2020-21 year the proposal needs to be included in the *Taxation (Annual Rates for 2020-21 Feasibility Expenditure and Remedial Matters) Bill.* This materially limited the time available for developing the policy and the draft legislation. Due to the short timeframe for development, officials only carried out targeted consultation. The policy has not been tested with the broader public.
Responsible Manager (signature and date):
Bary Hollow Principal Advisor Policy and Strategy Inland Revenue 11 February 2021

Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed the Loosening the loss continuity rules SAR and considers that the information and analysis summarised in it **meets** the quality criteria of the Regulatory Impact Analysis framework. The Key Limitations or Constraints on Analysis section of the SAR notes that analysis and consultation on options was limited after the Government announced it would implement a business continuity test in April 2020. While this may have limited analysis on options that were not preferred, consultation back to the Tax Working Group has identified the issues with a business continuity test and the analysis of the costs and benefits of the preferred option is well explained. The reviewer considers that the information in the SAR is as complete as could be expected and identifies the main risks and uncertainties.
Reviewer Comments and Recommendations:
Comments from the review of earlier versions of this SAR have been incorporated into this version.

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

Losses and income are treated asymmetrically under New Zealand's company tax system. Companies pay tax when their income is positive, but the Government does not provide a refund when income is negative. Refunding losses would be the most efficient way to recognise losses. However, no country in the world does this because it is fiscally expensive and raises integrity concerns around the artificial generation of losses to obtain refunds. Instead losses can be carried forward to offset future income of the company or other group income. Recognising tax losses in the system means that most taxpayers pay an appropriate amount of tax over their lifetime.

The loss continuity rules in the Income Tax Act 2007 set out the extent to which companies can carry forward tax losses to offset future profits when there is a change of ownership of the company. For losses to be carried forward at least 49% continuity of ownership of the company is required to be maintained from when the loss arose until the time it is used. New Zealand's rules are among the most stringent in the world and mean companies capital raising will forfeit losses if, in doing so, they have a change in ownership of more than 51%.

The purpose of these rules is to prevent loss trading. Loss trading is where there is little or no economic basis for a transaction in which a company acquires another company; the acquisition is made purely to access the tax losses to offset against its income. Loss trading presents a major risk to the revenue base. Where loss trading allows companies to avoid paying tax it undermines the integrity of the tax system and erodes social capital. Existing stocks of losses are very large, around $44 billion.

The 49% threshold limits any incentives to engage in loss trading because any income injected into that company to use up losses will also benefit the 49% of shareholders that have not changed. The threshold is a proxy for control, a change by more than 51% of the voting power in theory means that control of the company has changed.

The specific policy problem is that the focus on preventing loss-trading creates an impediment for companies obtaining capital in order to innovate and grow because capital raising can result in a breach of the 49% ownership continuity threshold. The impediment can lower the amount of capital an investor is willing to put into a company and that an existing owner is willing to accept. This is because any existing losses will have no value if there is a change in ownership and the company will have to pay tax on profits sooner as a result. In some extreme cases the rules can even prevent a transaction from happening at all. As much as possible, the tax system should not get in the way of sensible business transactions. Based on data collected by Inland Revenue from company tax returns, it is estimated that on average the tax value of losses forfeited by companies as a result of changes in ownership is $60 million a year.

The current settings prevent loss trading but arguably impede transactions which have nothing to do with the availability of a tax loss. The problem is particularly acute for start-ups as these businesses often have multiple capitalisation rounds as the business grows from an idea to a viable business. However, it is also recognised that companies seeking to recover from the impacts of COVID-19 have been undertaking capital raising in order to remain resilient (among other reasons).

2.2 Who is affected and how?

Currently, tax is acting as a barrier to sensible business decisions that companies can make to restructure their ownership and to bring in new investors. The evidence for this is anecdotally provided by stakeholders and has been included in submissions to Ministers and the Tax Working Group.[2]

2.3 What are the objectives sought in relation to the identified problem?

The objectives sought are to lessen the impact of the tax system on investment decisions in order to promote growth and productivity, particularly for start-ups and small-medium enterprises while still preventing loss trading opportunities.

[2] For example, the BusinessNZ submission to the Tax Working Group included a number of real examples where the loss continuity rules have been an impediment to capital raising. Accessed at: https://taxworkinggroup.govt.nz/sites/default/files/2018-09/twg-subm-3983184-businessnz-6-of-6.pdf

Section 3: Options identification

3.1 What options have been considered?

- Option 1 – Status quo
- Option 2 – Business continuity test
- Option 3 – Lower the ownership continuity threshold
- Option 4 – Introduce a formula for loss carry forward

Options 2-4 are all legislative tests which aim to loosen the loss continuity rules while still preventing loss trading.

All options were assessed against four criteria:

- *Fairness:* the options should improve horizontal equity so that different taxpayers with similar levels of income pay similar levels of tax.
- *Efficiency:* the options should lessen the impact of the tax system on economic behaviour.
- *Complexity:* the options should reduce complexity as much as possible.
- *Tax system integrity:* the primary function of a tax system is to provide revenue to fund government spending priorities. The options should maintain protection against loss trading which can reduce revenue and reduce social capital.

Option 1 – Status quo

This option is to retain only the current ownership continuity test. Companies would continue to forfeit tax losses if, through capital raising or other reorganisation, there is more than a 51% change of ownership.

Evaluation against criteria

Fairness: Taxpayers that have a 51% or more change in ownership while carrying losses forward have a higher effective tax rate over the same period of time compared with a company in a similar position but without a change in ownership which impacts on fairness between taxpayers.

Efficiency: The status quo would continue to impede capital raising and other sensible business reorganisations when these activities result in the forfeiture of losses.

Complexity: The current system is relatively simple in operation. Taxpayers and Inland Revenue, as the administrators, are familiar with the rules. However, some complexity can arise where taxpayers seek to avoid the forfeiture of tax losses due to an ownership continuity breach.

Tax system integrity: The current rules prevent loss trading which is their primary purpose. The status quo would maintain the robustness of the tax system in this area.

Option 2 – Business continuity test

This option allows losses to be carried forward after a change in ownership as long as the underlying business is fundamentally continued. Rules for New Zealand would be modelled on Australia's test with some modification to ensure they are flexible enough to permit the types of ownership changes businesses naturally make in order to maximise their profits.

Evaluation against criteria

Fairness: Overall, this option should increase fairness. For companies that meet the business continuity test the effective tax rate will be the same over its lifetime as a company in a similar situation but that does not have a change in ownership. However, the option would not improve fairness for all companies. For some, particularly at the margin, difficult fact situations will mean that the business continuity test will not apply to carry forward losses and the effective tax rate over time will continue to be higher than a company without a change in ownership. This will occur because it is difficult to design a subjective test that will apply to every situation while ensuring that loss trading opportunities are not created.

Efficiency: Overall, this option should increase efficiency because it allows a company to have changes in ownership without necessarily having to forfeit tax losses. However, the option also needs to build in flexibility for the company to make changes to its business that it could have done absent the change in ownership. It would be undesirable from an efficiency perspective for tax to limit the ways in which a company can develop and grow its business. A flexibly designed business continuity test can accommodate capital injections and allow the carry forward and use of losses that would have been forfeited due to the ownership continuity breach.

Complexity: There is potential for complexity arising due to the subjective nature of the test. Its application requires consideration of specific facts and circumstances. The test can be designed so that for most taxpayers its application to their situation is straightforward. This is achieved by making the test only as strict as it needs to be to prevent loss trading and ensuring that typical changes a business makes to its operations are well catered for. However, for some taxpayers the test will be challenging to apply to their unique facts and could require costly legal advice, which may include seeking taxpayer rulings from Inland Revenue.

Tax system integrity: The test limits the use of losses to the business that generated them. This protects against loss trading and ensures that other taxpayers are not able to use the losses to reduce their own taxable income from another business. Additional safeguards would be needed to ensure that facts are not manipulated in order to meet the business continuity test and engage in loss trading. This increases the complexity of the option compared to the status quo.

Option 3 – Lower the ownership continuity threshold

This option is to lower the current ownership continuity requirement from 49% to a threshold that reduces the number of transactions that would result in a breach.

Evaluation against criteria

Fairness: Lowering the threshold would continue to apply restrictions on transactions that breach that new threshold. In particular, transactions where all of the shares of the company are purchased would continue to result in the forfeiture of losses. While lowering the threshold increases fairness for companies that are able to carry forward losses that would have been forfeited under the status quo some companies will continue to experience breaches. Companies in this category would pay more tax over time compared to a company with a similar level of income that does not breach the new threshold.

Efficiency: The main benefit would be to allow increased new equity investment into a company before the ownership continuity rules are triggered and losses are forfeited. Capital raising may result in a majority change in shareholding that would otherwise breach continuity under the status quo. At the point of the new threshold the option would continue to limit sensible business reorganisations, for example 100% takeovers where there is less likely to be a loss trading motivation. Sometimes the strategy is to build up a business with a view to making it appealing for takeover by a larger company. This sort of activity can be beneficial to the New Zealand economy as often takeovers are necessary in order for a business to access global markets. It may be that being acquired by a larger company is preferred from an efficiency perspective. Lowering the threshold would not benefit such transactions. The problem with the status quo is not solved, only shifted.

Complexity: This option has the advantage of being simple to implement and, in theory, could be done relatively quickly. Some complexity could arise ensuring that there remains sufficient protection against loss trading.

Tax system integrity: Some preliminary modelling by officials demonstrated that the lower the threshold the easier it is to enter arrangements that create loss trading opportunities. Other supporting measures would be needed which would erode the simplicity of the option.

Option 4 – Formula for loss carry forward

Under this option losses could be carried forward after a breach in ownership continuity, but the amount of losses that could be used would be restricted by a formula related to the value of the company at the time of the continuity breach. The formula would be designed to approximate the value of the losses to the company had there not been a change in ownership. The formula would either be the value of the company:

- multiplied by some number to determine the stock of losses that can be carried forward; or
- multiplied by an interest rate to determine the amount of losses that can be used each year.

Evaluation against criteria

Fairness: This option would increase fairness to the extent it achieves its objective of preserving the value of a loss for more companies after a change in ownership. This is because the option should, in theory, provide most companies with the same ability to use their tax losses before and after the change in ownership. However, a formula does not accommodate increases in value from capital injections made to commercialise and expand the business (i.e., make it more valuable). Companies that are made more valuable because of the change in ownership will not have this factored into the amount or rate of losses available after a change in ownership. There are also challenges around setting the rate to multiply the company value by. It is unlikely that there is a single rate which can maintain the value of losses in all situations and trade-offs have to be made between fairness and ensuring that opportunities for loss trading are not created.

Efficiency: If a formula can closely approximate the value of losses in the absence of the continuity breach, it will improve efficiency. In theory, it should permit a company to seek new investment without considering the impact on its losses. However, a significant limitation of a formula is that it limits the use of losses based on the value of the company at the time ownership changes. As noted above, this does not accommodate increases in value from capital injections. This could be particularly problematic for high-growth start-ups that rapidly expand with capital injections. For this reason, and because of the difficulty setting a multiplier rate, a formula may continue to cause an impediment to capital raising activity by constraining the use of losses.

Complexity: It may be very difficult to design a formula which does maintain the value of losses for most companies after a change in ownership. This is due to the complexity surrounding the values to use in the formula. To work, a formula needs a company value and a rate to apply to that value in order to set the amount or rate of losses that can be used. The valuation of companies is a complex area. For public companies this information is readily available but for private companies it can be significantly more complex to determine. This option may result in large compliance costs for companies changing ownership that have to determine a specific value for use in the formula. While there are at least two other countries that take a formulaic approach (the United States and Sweden) public commentary on these tests almost universally agree they introduce significant complexity. The option did not get stakeholder support, primarily because of how complex it would need to be to work as intended.

Tax system integrity: A formula should maintain the integrity of the tax system. The theory behind a formula is that it should result in a situation where it never makes sense to pay for a tax loss alone. However, supporting rules would be required to ensure that the value of the company is not artificially inflated to increase the value of the losses the formula will permit to be used following the change in ownership.

3.2 Which of these options is the proposed approach?

The proposed approach is option 2, the business continuity test modelled on Australia's rules. Officials consider that is the best option on balance. Previously, officials have advised the Government that if it wanted to progress an option quickly as a COVID-19 response, the business continuity test would be the preferred option to develop on an accelerated timeline.

COVID-19 has shown that companies are able to pivot quickly into producing something else in response to external pressures. The proposed business continuity test can be designed so that the types of changes to the direction of a business that would have happened without the ownership change would be permitted and only the changes that mean losses become available to shelter the income of another taxpayer with no real interest in carrying on the business would be disallowed. The test will prevent loss trading by requiring the business itself to be continued.

A business continuity test has the advantage of international precedent having been picked up in some form by approximately 15 OECD member countries. New Zealand is able to look to other countries' success and failure in the design process which can help to minimise complexity.

Overall, the preferred option has significant support from stakeholders and, by drawing on international precedent, officials are confident that a test can be incorporated into the New Zealand system in a way that achieves the policy objectives. The test will allow businesses to reorganise or recapitalise without unduly restricting what they can do after a change in ownership. However, the option necessarily limits, for integrity reasons, the amount of change that can occur. For some companies this means that the business continuity test will result in the forfeiture of losses. This is an appropriate result where the fundamental business of the company has changed because without such a limitation it would be possible to engage in loss trading activity.

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties *(identify)*	**Comment**: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts*
Additional costs of proposed approach, compared to taking no action		
Regulated parties Companies	The test is subjective so there are interpretation risks that will apply at the margin to reduce the overall benefit. Some companies may not be able to use the rules even though they are not loss trading. Legal advice on specific facts and circumstances may need to be sought. However, the 49% ownership test will remain and can be relied on to carry losses forward. Companies are not required to make use of the business continuity test.	Low
Regulators Inland Revenue	Some administrative costs associated with monitoring companies relying on the business continuity test, updates to website and other standard implementation tasks. This would be met within existing baselines.	*Low*
Wider government	Losses that would previously have been forfeited can be carried forward to offset profits that the company would have to pay tax on if no action were taken and they were not able to retain losses after an ownership change. This results in a loss of revenue to Government.	Up to $60 million less revenue collected a year. This figure is the average tax value of all losses that are forfeited in an average year. It is an upper bound to the expected cost under the Australian test, if all forfeited losses were able to be absorbed each year.
Other parties	N/A	N/A

Total Monetised Cost		Up to $60 million forgone revenue a year.
Non-monetised costs		*Low*

Expected benefits of proposed approach, compared to taking no action		
Regulated parties Companies	Losses that would previously have been forfeit can be carried forward to offset profits that companies would have to pay tax on if no action were taken and they were not able to retain losses after an ownership change. Companies are able to raise capital without losing access to losses and so can seek out opportunities to grow and innovate.	Up to $60 million a year tax saved for companies *Medium*
Regulators Inland Revenue	N/A	N/A
Wider government	N/A	N/A
Other parties	N/A	N/A
Total Monetised Benefit		Up to $60 million a year
Non-monetised benefits		*Medium*

4.2 What other impacts is this approach likely to have?

The proposal impacts all corporate taxpayers. However, it only has relevance for company lifetime events that are irregular major transactions and does not have wider implications for companies that are not changing ownership. It does not impact individuals or trusts as continuity rules do not apply to them.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?
Stakeholders have long been advocating for change in this area with submissions on the problem being made to the Tax Working Group and to Ministers directly. In September 2019 the Government announced it would consult on options to loosen the loss continuity rules. Following this, officials engaged with a range of stakeholders as part of an early engagement process ahead of planned formal consultation. This consultation sought preliminary views on the options that should be considered and what the advantages and disadvantages of each might be. During this process most stakeholders expressed a preference for a business continuity test. However, in order to progress a solution along a quicker timeline in response to COVID-19, the Government agreed that targeted consultation on only the business continuity test should be carried out with key stakeholder groups. The specific stakeholders consulted were the Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand and members of the New Zealand Law Society Tax Law Committee. A small group of stakeholders from both smaller and larger advisory firms was also set up for consultation. These stakeholder groups were chosen as they are representative of those who will use the test and advise on it. Stakeholders are in agreement with the problem and the proposed approach to resolving it. The feedback has been that they are pleased to see a solution to the problem developed that is closely related to the problem definition. Adaptation of the Australian test to work in a New Zealand context has been done in conjunction with the stakeholder groups. In particular, the Australian test has been modified in response to stakeholder feedback in order to focus on inputs a company uses in its business rather than outputs. Focusing on what resources a company uses to generate income better focuses on what the underlying business is. Focusing on products does not recognise that companies often seek out new applications for their intellectual property or asset base and that this suggests evolution not loss trading. The test has also been made more permissive by incorporating the approach taken by the United Kingdom to a business continuity test. This is a modification from the test requiring a company to demonstrate it remains the same/similar to carry the losses forward (Australian approach) to assuming the company can carry losses forward unless it has a major change in its assets or activities. This approach focuses on ownership changes where the underlying business is continued, rather than requiring an assessment of how static the business of a company is. The key concern remaining for stakeholders is that the test may still prevent some companies from carrying losses forward for which there is no reason to exclude. This is because the business continuity test has boundaries to ensure that changes that are too significant will not pass. Without these boundaries loss trading opportunities could arise but they do create a limitation for genuine commercial changes to the business that sit outside of what the test permits. However, stakeholders generally agree that these should only be at the margin and that the rules can be reviewed following implementation to see how they are working in practice.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?
The new rules will be legislated via the *Taxation (Annual Rates 2020-21, Feasibility Expenditure, and Remedial Matters) Bill*, and will apply to changes in ownership which breach the 49% threshold that occur in the 2020-21 or later income years. In conjunction with the enactment of the legislation, Inland Revenue will publish guidance on the new rules so that taxpayers and advisors are aware of them and have time to prepare. This guidance would also provide taxpayers something to rely on to interpret how the rules apply to them. The current rules for loss carry forward require a taxpayer to self-assess their eligibility. The new business continuity test operates in the same self-assessment model so a long lead-in period is not necessary. Taxpayers are already required to maintain records to support a tax position taken for at least seven years. Inland Revenue will be responsible for the ongoing operation and enforcement of the proposal. No concern has been expressed about Inland Revenue's ability to do so. Inland Revenue already carries out this function with respect to the existing loss continuity rules. Compliance with the new rules will be monitored through routine compliance activities.

Section 7: Monitoring, evaluation and review

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

Officials regularly meet with stakeholder groups and can use these meetings to seek feedback on how the rules are working for taxpayers once they are in force. Feedback from Inland Revenue Customer Compliance Specialists will also be sought in relation to how the rules are working administratively.

Data will be collected on taxpayers that have a change in ownership. This will allow information to be collected on the numbers of companies making use of the new regime. It will also provide information on the value of losses these companies are carrying forward under the business continuity test.

Inland Revenue already collects data on losses carried forward as taxpayers must include this in annual returns. However, this information would not provide insight into how well loosening the loss continuity rules is working to encourage growth and innovation outcomes. It will be easier to measure the ability of the new rules to prevent loss trading. As loss continuity rules exist to prevent this activity it will be considered a successful outcome to observe companies carrying forward losses after a change in ownership without there being evidence of loss trading.

7.2 When and how will the new arrangements be reviewed?

A post-implementation review plan has been agreed between Inland Revenue and the Treasury. If appropriate, a survey of companies relying on the test could be carried out to get additional information.

This review would cover the amount of losses that are still estimated to be lost each year. From 2022 information on the business continuity test will be available to Inland Revenue audit function. This should allow for a risk review and for information on whether there is any loss trading as a result of the policy. Due to the nature of tax changes it is likely to take several years before the impacts of the policy can be properly assessed. In 3-5 years there should be sufficient data to determine how well the rules are working and whether any aspects need to be revisited.

Policy officials maintain strong communication channels with stakeholders in the tax advisory community, and these stakeholders will be able to correspond with officials about the operation of the new rules. If problems emerge, they will be dealt with either operationally, or by way of remedial legislative amendment if needed.

Regulatory Impact Statement: Review of Unclaimed Money Act

Section 1: General information

Purpose

Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Assessment, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of final decisions be taken by Cabinet.

Key Limitations or Constraints on Analysis

Scope of review

The scope of the review of the Unclaimed Money Act 1971 (the Act) focused on modernising the administration of the Unclaimed Money (UCM) system. Because of time constraints to ensure that any legislative changes were enacted to coincide with the deployment of the next BT release, the review did not undertake a first principles review of the scope of the Act including the holders and unclaimed money that could be covered by the Act. There are a number of pieces of legislation that cover unclaimed money and assets and the review did not consider the consolidation of this legislation.

Responsible Manager (signature and date):

Mike Nutsford
Policy Lead
Policy and Strategy
Inland Revenue
15 January 2021

Quality Assurance Reviewing Agency:

Inland Revenue

Quality Assurance Assessment:

The Quality Assurance reviewer at Inland Revenue has reviewed the *Review of Unclaimed Money Act* Regulatory Impact Assessment prepared by Inland Revenue, and considers that the information and analysis summarised in the Regulatory Impact Assessment meets the quality assurance criteria.

This RIA is an updated version of the RIA originally completed on 24 April 2020 to reflect additional changes proposed to be incorporated in a Supplementary Order Paper at the Committee of the whole House stage of the *Taxation (Annual Rates for 2020-21, Feasibility Expenditure, and Remedial Matters) Bill*. This RIA considers a large number of small changes to the unclaimed money rules to improve its overall efficiency. In comparison with a RIA that considers a single or small number of larger changes, this makes it practically difficult for the pros and cons of individual changes to be fully explained. The RIA provides a good explanation of why the changes should proceed and we consider the summarised detail on the individual proposals does not subtract from the overall conclusions reached.

Reviewer Comments and Recommendations:
The reviewer's comments on earlier versions of the Regulatory Impact Assessment have been incorporated into the final version.

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

As part of Inland Revenue's business transformation (BT) programme, the administration of the Unclaimed Money Act 1971 will be integrated into our new technology platform (START). This is currently scheduled to take place in April 2021. Currently UCM is administered as a stand-alone product using paper based and spreadsheet information provided by a holder of UCM. Inland Revenue is unable to use information it holds as part of administering the tax and social policy system to assist in identifying owners of unclaimed money.

Our BT programme provides an opportunity to review the administration of the UCM system to modernise its administration to reduce compliance costs for holders of UCM and administration costs for Inland Revenue (IR). The Act has not been reviewed since it was enacted in 1971 and that Act was very much based on the original 1908 Act.

Unclaimed money ("UCM") is the term applied to money subject to the regime established by the Unclaimed Money Act 1971 (the "Act"). Most often, this takes the form of deposits which have been left untouched by their owner in their bank accounts for some years, or even decades. UCM holders are not limited to banks, however, as UCM can arise in a variety of contexts and among other service providers (e.g. real estate agents, lawyers and utility providers) whose role is often to hold monies on trust. KiwiSaver contributions held by IR that cannot be allocated to a KiwiSaver scheme or member are also treated as unclaimed money.

Eventually, in situations in which contact with the depositor is lost, these amounts become "unclaimed" and are transferred to IR. Such amounts are deposited into the Crown's bank account and can be used by the Crown. UCM is a contingent liability in the Crown's accounts. The Crown does not pay interest on UCM when it is paid out to its owner. As at November 2019, IR's UCM database had a total value of approximately $199m (including amounts from KiwiSaver). In the period 1 November 2018 to 30 November 2019, IR received approximately $13 million in transfers of UCM from UCM holders. IR then seeks to locate the owners of UCM, and makes information available so owners can contact IR, so their money can be returned to them. This is the regime's ultimate aim: the reunification of UCM owners with their money. In the period 1 November 2018 to 30 November 2019 IR returned approximately $2.4 million to UCM owners.

However, aspects of the UCM regime have either become outdated or do not accommodate technological developments which have occurred since the enactment of the Act. This has resulted in the Act not meeting its policy objective of efficiently reuniting owners of UCM with their money. For example:

- The Act currently applies different "deeming" periods (i.e. the period which must elapse before money becomes UCM) to money based on its "product" category. For example, a deposit made for a fixed term and a deposit made for an unlimited term will be subject to different qualifying periods. The deeming period in the former case is six years, while in the latter case, it is 25 years. Other examples of such product distinctions can also be found within the Act. These product distinctions are somewhat artificial and relevant timeframes lengthy.

- In some cases, for the relevant deeming period to have expired on a deposit, the owner must not have operated on the account for the relevant period, by "deposit, withdrawal or instruction in writing". This does not account for new forms of activity developed since the Act's enactment such as telephone or internet banking. Accordingly, it is possible that some amounts of money may become UCM notwithstanding their owners taking an active interest in their administration.

- The Act currently requires a holder of UCM to keep a physical register of the UCM which has accrued in the current year, and to make this register available for inspection by the public. As modern data storage is largely digital, maintenance of a physical register does not take advantage of new technological developments, thereby imposing compliance costs on UCM holders. This requirement also raises privacy issues, as the physical register is required to record, among other things, the name, occupation and last known address of the owner.

- Once money has become UCM, UCM holders may end up holding it for almost 12 months as they proceed through a somewhat convoluted statutory process. This in summary requires a holder of UCM to:

    - maintain a register of money which has become unclaimed in the period 1 June of the preceding year to 31 May of the current year (and to make this register available for inspection by the public);

    - by the end of June in the current year, write to the UCM owner's last known address, and provide the particulars of money which has become UCM;

    - by the end of September in the current year, provide the Commissioner with a copy of the register of the money which has become UCM in the current year (the UCM holder must also advise the Commissioner of any amounts which have been paid to the owner since the end of June in the current year year) and

    - by the end of October each year, pay any UCM which has been left unclaimed to the Commissioner.

- This process is both lengthy and administratively taxing for UCM holders. It also does not envisage new methods of information transfer (e.g. electronic data transmission in an agreed format).

- While UCM holders are required to provide IR with the occupation information of UCM owners, there is no requirement to provide any other information which they may hold (e.g. IRD numbers, date of birth and contact details such email address and the like) and which may be more helpful in locating owners of UCM.

- UCM holders are currently unable to transfer money to IR before the deeming period has expired. This would be beneficial in limited circumstances (e.g. as part of a routine remediation process). This means that UCM owners end up waiting much longer than is necessary for IR to have the opportunity to reunite them with their money.

- The Act is currently not listed in Schedule 1 of the Tax Administration Act 1994 as an Inland Revenue Act. This means that IR is unable to use existing tax information to facilitate the more efficient matching of owners with their UCM.

- Currently, there is no limitation (or "time bar") on the period during which UCM may be claimed by a prospective claimant from IR. This means that there is an ongoing contingent liability on the part of the Crown for all UCM currently held. The reasoning for installing a time bar is as follows:

- it recognises that there is a point in time beyond which owners are unlikely to ever make a claim for UCM. This reflects a judgment that the probability of an owner claiming UCM eventually becomes extremely remote. This makes retaining UCM as a contingent liability on the Crown's accounts indefinitely impractical as there comes a point at which the liability ceases, for practical purposes, to exist; and
- from a cost-benefit perspective, it could be said that the cost and duties imposed on regulators (and regulated parties) outweigh the benefits to individual owners of UCM

2.2 Who is affected and how?

UCM holders

As noted in the examples above, UCM holders bear administrative costs in the form of outdated information collection and storage requirements. UCM holders are unable to take advantage of new methods of communication (e.g. email) when seeking to contact owners of UCM or transferring information to IR.

UCM owners

Owners of UCM are affected by the administrative requirements of the current regime which does not optimise their chances of being reunited with their money. The lengthy "deeming" period and requirement to use traditional methods of contact (i.e. post) means that some owners may miss out on being returned their UCM. The inability of IR to use existing tax data to match owners of UCM with their money makes IR's matching processes less than optimal.

Inland Revenue

Under the Act, IR is required to receive physical copies of UCM records kept by UCM holders. It also unable to use existing tax data to match owners of UCM with their money, which presents a source of administrative inefficiency and increased cost.

2.3 What are the objectives sought in relation to the identified problem?

The objectives of the proposals are to:

- modernise and update the Act to take advantage of new administrative practice;

- reduce compliance costs for holders and owners of UCM;
- reduce administrative costs for IR; and
- increase the likelihood of owners of UCM being reunited with their money (and more rapidly than is presently the case).

Section 3: Options identification

3.1 What options have been considered?

The following criteria were used to assess the options considered:

- *Compliance:* compliance costs should be minimised as far as possible.
- *Administration:* administrative costs should be minimised as far as possible.
- *Equity:* the option should ensure that UCM owners are, so far as possible, being reunited with their money.
- *Sustainability:* the option should be consistent with wider financial practice settings and utilise modern communication practices.

Option One: Maintain the status quo

Compliance: The cost of collating UCM and dispatching letters to the last known addresses of its owners can be costly for UCM holders both in time and in the resources required.

Administration: The status quo requires IR to use its resources less than optimally by attempting to match UCM with its owners using information which may be limited or outdated.

Equity: Some owners of UCM are not being reunited with their money due to a lack of information. Another factor is the inability of IR to reconcile information collected from UCM holders with current tax data held by IR.

Sustainability: The current UCM regime settings were doubtless intended to promote best administrative practice when originally enacted, but now pose a burden for UCM holders who are required to undertake a process which is no longer in keeping with current business practice.

Option two: Administrative refinements and reforms

Option two would use the opportunity created by the next Business Transformation Release ("BT 5") to update the Act and modernise the UCM regime. BT 5 is the final step in the modernisation of IR's computer systems. The proposals which address the issues noted above by making the following changes to the administration of the UCM Act:

- The "qualifying" or "deeming" period which must elapse before money is deemed unclaimed could be reduced from six or 25 years (depending on the UCM category) to five years for all UCM categories. (This would not, however, encompass deposits made for a term of five years or more, as the "deeming period" would not begin until the deposit reached maturity).

- The definition of unclaimed money should be amended to allow new forms of activity on an account (e.g. online activity) to prevent an amount of money being deemed UCM.

- UCM holders could in limited circumstances (e.g. where a service provider seeks to refund money to a former client who cannot be located as part of a remediation process), be permitted to transfer money to Inland Revenue *before* the requisite period for deeming unclaimed money has elapsed.

- UCM could be able to be transferred to IR immediately upon being classified as unclaimed money, provided that reasonable efforts have been made to contact the UCM owner over the intervening period. Where reasonable efforts have not been made to contact the owner, the UCM holder should retain the funds for an additional three-month period during which the holder must seek to contact the UCM owner before transferring the UCM to IR.

- The requirement for UCM holders to maintain a physical register of UCM at their head office or place of business could be removed. As UCM could be paid to IR immediately upon qualifying as such, record keeping requirements could be limited to retention of a record evidencing the *transfer* of the UCM to IR, for seven years.

- The requirement for UCM holders to provide occupation information could be removed. Instead, UCM holders should provide IR with other identifying information (e.g., IRD numbers, date of birth and contact details) where collected in the ordinary course of their business (IR would still accept occupation information if available and provided, however).

- The UCM threshold should be retained where it is presently (i.e., $100), while also giving the Commissioner the discretion to accept smaller amounts if necessary.

- A 25 year time bar on a prospective claimant's ability to claim UCM would be introduced. A prospective claimant would have 25 years within which to claim money to which they are entitled from IR. This will allow the Crown to remove its contingent liability for UCM at the end of a sufficiently long period to enable claimants to access those funds. As mentioned above, this a judgment that the probability of an owner claiming UCM becomes extremely remote. Retaining UCM as a contingent liability on the Crown's accounts indefinitely is impractical. Compared to the status quo the introduction of a time bar removes a property right in that if the money is not claimed within the 25 year period, it will become the Crown's money.

- Amounts of UCM of $100 or less will be made unclaimable and vested in the Crown. IR estimates that it currently costs approximately $130 to administer a single claim for UCM. This means that it is uneconomic to administer some amounts of UCM. This proposal is intended to promote administrative efficiency by ensuring that IR's resources are more proportionately applied to amounts of money which are economic to administer.

- Amounts of UCM which do not have any information associated with them will be made unclaimable and vested in the Crown. This is intended to recognise that it is all but impossible to establish a claim or locate an owner for UCM which has no data associated with it.

- The Unclaimed Money Act 1971 would be listed within Schedule 1 of the Tax Administration Act 1994 in order to define it as an Inland Revenue Act In order to align with IR's BT 5 timetable, this will need to occur with effect from 1 March 2021. The application of Parts 4A (Disputes), 7 (Penalties) and 8 (Interest) of the Tax Administration Act 1994 would be excluded as they are not applicable to UCM. This would allow IR to use its existing tax data to more efficiently match owners of UCM with their money.

- Section 83 of the KiwiSaver Act 2006 applies to employer and employee contributions which the Commissioner is unable to process due to a lack of sufficient information. However, it currently refers to the existing deeming periods of 6 and 25 years. This will need to be updated to include the consolidated, 5 year deeming period contained within the proposals.

- Holders of UCM should be allowed to transfer UCM and associated information to IR on a quarterly (or, where the Commissioner agrees) six monthly basis, with filing due 1 month and 20 days following the conclusion of the chosen period. This would streamline administration for holders.
- As different dates can apply to determine how long the Commissioner has held KiwiSaver contributions, the KiwiSaver Act 2006 should be amended to provide that KiwiSaver contributions without associated data are deemed to have been received on the last day of the month to which the employment information applies. This is intended to ensure that the length of time employment contributions have been held by the Commissioner can be readily determined for the purposes of the Act.
- The Act should be brought within the binding rulings regime to ensure that holders are able to obtain certainty about the Act's application to their specific circumstances. This will help holders to ensure they comply with their obligations under the Act.
- Holders should be able to apply to the Commissioner for a delay of up to two years in the Act's application. This will allow the Commissioner to work with holders on a case-by-case basis in order to facilitate compliance with the reforms.
- UCM holders could be required to provide information and UCM to IR electronically and in a standard format.

Administration: the option proposed above would increase administrative efficiency and reduce administrative costs.

Compliance: the changes above would reduce ongoing compliance costs for holders of UCM overall. However, the requirement to provide information to IR in a standard format may result in an increase in upfront compliance costs for some holders of UCM to comply with the new requirements, although this should be mitigated through ongoing consultation and dialogue with stakeholders in the legislative design process.

Equity: the additional information received from accounts holders and new ability to use existing tax data will assist IR in matching owners of UCM with their money, and more rapidly than is presently the case.

Sustainability: This option enhances the current UCM administrative settings. Implementing all the above changes as a "package" would maximise efficiency and compliance cost reduction.

This approach is compatible with the Government's *Expectations for the design of regulatory systems*.

3.2 Which of these options is the proposed approach?

Option Two is officials' preferred option. This option addresses the issues outlined in section 2.1 above by updating the UCM Act to take advantage of technological developments in data storage and transmission. It reduces compliance costs for UCM holders by removing many outdated administrative requirements and allows for the faster transfer of money to IR. It also reduces administrative costs for IR by allowing it to use existing tax data to match owners of UCM with their money. In this way, owners of UCM are more likely to be reunited with their money, and more quickly.

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties *(identify)*	**Comment**: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts*
Additional costs of proposed approach, compared to taking no action		
Regulated parties (*holders of UCM)*	Minor costs in the form of UCM holders being required to update their systems in order to account for changes to the existing UCM regime. There may also be some small costs for UCM holders in being required to supply information in a standard format. Officials will continue to consult with stakeholders in order to keep these costs to a minimum and ensure that stakeholders have sufficient time to upgrade their systems.	Low
Regulators *(Inland Revenue)*	IR will bear some cost in amending its systems to incorporate the changes required by the proposals These system changes and the associated cost will be undertaken as part of Inland Revenue's BT release 5 deployment and will not require additional funding.	Low/Med
Wider government	None	None
Other parties	None	None
Total Monetised Cost		None
Non-monetised costs		Low

Expected benefits of proposed approach, compared to taking no action		
Regulated parties	Compliance cost savings for UCM holders who are who will no longer be required to conform to a range of outdated regulatory requirements.	Low/Med
Regulators *(Inland Revenue)*	Cost savings arising from operating a simplified regime.	Low
Wider government	None	None
UCM Owners	Compliance cost savings for owners of UCM who will have an increased chance of being reunited with their money, and of receiving it more rapidly.	Med

Total Monetised Benefit	None	None
Non-monetised benefits	Reduced compliance costs for UCM holders and administrative benefits for Inland Revenue.	Med

4.2 What other impacts is this approach likely to have?

While the purpose of the change is to improve the efficiency of IR's administration and reduce compliance costs for holders and claimants, there is a risk that deposit takers may not prioritise efforts to reunite monies with beneficial owners by instead relying on Inland Revenue to fulfil the role of the Act. Officials consider this risk is low as industry regulations on deposit takers generally impose certain duties and obligations in respect of taking that deposit.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?
Consultation with stakeholders occurred following the release of IR's consultation document *Unclaimed money: A tax policy consultation document* on the public tax policy website in January 2020. Officials either met with (or received submissions from) 16 individuals, organisations or businesses. These included Business New Zealand, the New Zealand Law Society, the New Zealand Bankers' Association and the Office of the Privacy Commissioner. Reforms to the administration of UCM were incorporated into the *Taxation (Annual Rates for 2020-21, Feasibility Expenditure, and Remedial Matters) Bill* (the "Bill") by Supplementary Order Paper 510 (SOP).Seven submissions on the SOP were received by the Finance and Expenditure Committee. Stakeholders were generally supportive of the proposals, but eager for consultation to continue on matters that could present compliance costs (e.g. movement toward a new definition of UCM and standard format for the supply of information, etc). Stakeholders also sought sufficient time to allow them to transition their systems to the new regime. Some minor changes to the proposals have occurred following consultation. These include: • formalising IR's ability to accept smaller amounts of money (which fall below the current, $100 threshold); and • allowing UCM holders to, in limited circumstances, transfer money to IR *before* it becomes UCM. Other changes to proposals following review of submissions to the Finance and Expenditure Committee include: • the ability for holders to file on a quarterly (or where the Commissioner agrees) six monthly basis; • the inclusion of the Act within the binding rulings regime; • the ability for holders to apply to the Commissioner for variation which would leave up to two years before the reforms applied to them. These changes have been developed in response to information gathered in the course of consultation.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?
The initial reforms were included as a SOP to the *Taxation (Annual Rates for 2020-21, Feasibility Expenditure, and Remedial Matters) Bill* . The SOP was referred to the Finance and Expenditure Committee for its consideration and calling of submissions on the proposed law changes (wherethe Committee so decided). Revisions and further proposals are intended to be incorporated into a further SOP to be referred to the Committee of the whole House for incorporation into the Bill. Inland Revenue will be responsible for the operation of this preferred option, which will form part of its business as usual function.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
Inland Revenue would monitor the effectiveness of the proposed reforms to the UCM legislation on an ongoing basis. In the event IR should identify any issues in the operation of the new regime, IR would undertake a review of the legislation in order to assess whether further amendments or reforms may be required.

7.2 When and how will the new arrangements be reviewed?
Officials will be kept appraised of operational developments as they arise by the IR team responsible for operating the UCM regime and for liaising with UCM claimants. Officials will also maintain contact with the IR team responsible for implementing the systems changes necessary as part of BT5, who will also keep officials updated of developments.

4.

Coversheet: Tax measures to moderate house price growth – extension of the bright-line test

Advising agencies	*The Treasury*
Decision sought	*Agree to extend the bright-line period for property acquired on or after the application date.*
Proposing Ministers	*Minister of Finance* *Minister of Revenue* *Minister of Housing*

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 is to support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers. Access to affordable housing is important to support the living standards of New Zealanders. Rates of homeownership have reduced significantly from their peak in the 1990s, particularly for younger people, increasing intergenerational inequity.[1] Investors account for a significant portion of house purchases, reducing the number of houses available for new owner-occupiers. Rising housing costs are also having an impact on renters.[2] While the tax system is not the primary driver of housing affordability, current tax settings incentivise investment in housing. This is because a significant source of economic income from residential property, capital gains, is not fully taxed. This creates equity issues compared to earnings from salary and wages, which are fully taxed. Not fully taxing some economic income from property investment encourages inefficient investments (compared with other possible investment options), with flow-on impacts for the housing market.

Summary of Preferred Option or Conclusion (if no preferred option) **How will the agency's preferred approach work to bring about the desired change? Why is this the preferred option? Why is it feasible? Is the preferred approach likely to be reflected in the Cabinet paper?**
An options analysis would consider different ways to more consistently tax income. However, the Government has ruled out new taxes or taxes on the family home. The Government has also ruled out comprehensive taxation of capital gains or a risk-free return method tax.

1 Stats NZ, data from 1916-2018 Censuses. https://www.stats.govt.nz/news/homeownership-rate-lowest-in-almost-70-years

2 HUD analysis and CoreLogic (monthly)

This Regulatory Impact Statement has been produced under extremely tight time constraints without consultation or the benefit of robust data, and accordingly there is a risk that the analysis is incomplete or may miss key interactions. It represents the Treasury's best assessment of the options identified by the Government in the time available.

Bright-line test extension

In light of the Government's objectives and the above constraints, on balance the Treasury's preferred option is an extension of the bright-line period from 5 years to 20 years with no exemption for new builds.

While tax settings are not the primary driver of problems in the housing market, extending the bright-line test should put downward pressure on house prices in the short to medium term, and provide equity and efficiency benefits in taxing more economic income. However, extending the bright-line test may put upward pressure on rents.

While the extension may result in lock-in effects, the additional costs of these are unclear. The Treasury's view is that lock-in will not significantly reduce housing utilisation.

Therefore, the Treasury considers the measure improves the tax system on balance and contributes to the Government's stated demand-side housing objectives: to support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers.

The Treasury's preferred option is a 20-year bright-line test, however it also considers a 15-year bright-line test is superior to the status quo, as it would help meet some of the Government's housing market objectives - but not to the same extent as a 20-year bright-line test. In the time available, the Treasury has not formed a view on whether a 10-year bright-line test is preferable to the status quo.

The Treasury does not recommend providing an exemption from the extended or existing bright-line test for early investors in newly constructed homes. An exemption comes with additional administrative and compliance costs, and over time reduces the coherence of the tax system. While increasing housing supply is important, the Treasury considers there are likely to be better ways to directly support supply, for example through an explicit subsidy for developers. If the Government does proceed with an exemption, the Treasury prefers that exempt houses remain subject to the 5 year bright-line rule.

Interest deductibility

Given time constraints and lack of analysis, the Treasury does not recommend progressing the interest deductibility proposal without further analysis. The Treasury recommends further regulatory impact analysis and consultation be undertaken before final decisions are made on this measure.

This Regulatory Impact Statement addresses the extension to the bright-line test only.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?

Bright-line test extension from 5 to 20 years (no new build exemption)

The main benefit of the proposal is distributional. The primary beneficiaries of extending the bright-line period are new owner-occupiers, to the extent these measures result in lower house prices than otherwise. The distributional benefits will also depend on the use of additional Crown revenue to the extent that additional tax is paid as a result of these measures.

There are also wider system benefits: efficiency increases as more economic income is taxed, and 'lock-in' impacts are potentially mitigated around the five year mark; horizontal equity improves as the tax treatment of capital income is brought into closer alignment with labour income; and vertical equity improves as the progressivity of the tax system increases.

These benefits would arise to a lesser extent with a bright-line extension to 10 or 15 years. A shorter extension is likely to reduce lock-in around the 5-year mark less, but create less lock-in for houses held for longer periods.

Where do the costs fall?

Bright-line extension from 5 to 20 years (no new build exemption)

The costs of extending the bright-line period to 20 years fall primarily on residential property investors and potentially renters, although there is considerable uncertainty about the magnitude of the impact on rents. These costs would be less for a shorter extension.

To the extent that house prices are lower than otherwise, the costs would fall on existing residential property investors. Expected after-tax returns are not expected to change for new residential property investors, although investors may face a higher than expected ex-post tax liability for selling within the period if there are unexpected capital gains.

To the extent that rents are higher than otherwise, the costs would fall on renters who do not purchase a home. This would disproportionately affect low-income households, younger people, Māori, and Pacific peoples. Extending the bright-line could decrease the supply of rentals over the long-term. There are many factors affecting rents beyond rental supply, including renters' income levels. This means the impact an extension will have on rents is difficult to quantify, but there is a risk there could be upward pressure.

There would also be additional compliance and administrative costs to the extent that more taxpayers are captured by the bright-line extension.

Lower house prices than otherwise would also reduce the housing wealth of existing housing owner-occupiers. However, this would not necessarily have direct impacts on their consumption, although it may have impacts for those that wish to reduce their housing consumption (as they would realise less wealth from down-sizing).

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

There is a general risk associated with analysing the impacts of this measure in a condensed timeframe and in isolation from the supply-side proposals being considered by the Government. These interventions are complex, and their interactions are liable to produce unforeseen outcomes.

Bright-line extension:

Lock-in effects

Extending the bright-line test would impact the 'lock-in' effect for properties held for a longer period, compared with the status quo. The lock-in effect refers to the incentive investors have to hold onto property until the bright-line period has expired to avoid a tax liability. In theory, the lock-in effect reduces housing liquidity.

The strength of the lock-in effect increases with a longer bright-line period, because the potential capital gain would be relatively larger. However, a longer bright-line period would reduce lock-in in the early years as compared to status quo (or a shorter period), as people may be less willing to hold onto the property for a much longer period. Due to these competing effects, it is not possible to say what period minimises lock-in.

While on balance, we do not expect lock-in to have a significant impact on housing utilisation, there is a risk that extending the bright-line could lead to a more significant lock-in impact than anticipated and/or greater economic costs than anticipated.

Long-run supply issues

Extending the bright-line period may lead to fewer houses being built in the long-run than otherwise would be under the status quo. There is a risk that any decrease in supply will partially or fully offset the extension's short to medium-term decrease in house price growth over the long-term. Higher prices from lower supply diminishes the measure's benefits to new owner-occupiers, and lower rental supply potentially increases rents.

Rental market affordability

Any reduction in the supply of residential rental properties, due to the reduction in investors buying and renting out property, may put upward pressure on rents. It is possible that a higher level of homeownership among former renters does not completely offset the pressure on rental prices, as owner-occupiers may have smaller households. Alternatively, to the extent that rents are set by income levels, they may not increase.

Bright-line extension (new build exemption):

Exempting new builds from an extended bright-line test could go some way to mitigating the risks associated with an extension. Most of the risks associated with a bright-line extension relate to the uncertainty around the magnitude of the extension's costs and benefits, and any impacts on supply and rents. An exemption mitigates these risks by weakening the costs and benefits, meaning an extension with an exemption would produce an outcome closer to the status quo than an extension without an exemption.

This comes at the cost of lower expected benefits, and additional compliance and administrative costs.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?
There is a low rating of evidential certainty. This analysis has been prepared under significant time constraints and faces substantial data limitations. There are complex interactions between potential measures that have not been analysed.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
The Treasury's Regulatory Impact Analysis Team and Inland Revenue have reviewed the Regulatory Impact Statement (RIS) "Tax measures to moderate house price growth – extension of the bright-line test" produced by the Treasury and dated 5 March 2021.
Quality Assurance Assessment:
The review panel considers that it **partially meets** the Quality Assurance criteria.
Reviewer Comments and Recommendations:
While realising that the tax system is not the primary driver of housing affordability, the Treasury has identified a number of options to help partially address the housing problem. The Treasury's preferred option is to extend the bright-line test from 5 years to 20 years with no exemption for new builds. A framework with a comprehensive set of criteria has been developed to assess these options. However, limited consultation has been undertaken due to significant time constraints. The denial of interest deductions is another policy option that has been identified, but in the time available, the Treasury has not been able to undertake impact analysis. Further, no analysis has been undertaken on how this measure would interact with the extension of the bright-line test. The Treasury has agreed that a Supplementary Analysis Report (SAR) relating to this proposal will be incorporated into an upcoming consultation process. After this consultation, a full RIS will be produced for the final policy decision at the Cabinet.

Impact Statement: Tax measures to moderate house price growth – extension of the bright-line test

Section 1: General information

1.1 Purpose
The Treasury is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, 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.

1.2 Key Limitations or Constraints on Analysis
Limited options: The analysis is limited by the tax options already ruled out by the Government, including a comprehensive capital gains tax, a tax on a deemed rate of return for residential property, a wealth tax, or any new measure outside of the current tax framework. The options analysed in this Regulatory Impact Statement are at the direction of Ministers.

Supply-side measures:

The Government intends to progress a complementary set of supply-side measures which are expected to increase housing supply and lower rents. The impacts of these supply-side measures have not been included in the impact analysis in Section 4. As a result, the impacts of the demand-side tax measures have not been considered in the context of any supply-side measures.

Significant time constraints:

This analysis has been prepared under significant time constraints. Accordingly, elements of the analysis might not be sufficiently robust. Due to time constraints, there has been no opportunity for consultation with external stakeholders.

Lack of empirical data:

This analysis on what impact this initiative will have on the housing market is constrained by a lack of empirical data. Where evidence is not available, a theoretical assessment of the expected impact has been provided. While some empirical data is available from the current application of the bright-line test, it is difficult to isolate the impact of that policy change from other influences on the housing market over the relevant time period.

Projected revenue:

Revenue impacts from the bright-line extension have been undertaken through static analysis, given it is not possible to estimate the behavioural impacts of the measure. Examples of unknown behavioural effects are how many people would sell within 5 years or, after 20 years, how much lock-in would occur over the long-term, and the size of the reduction in the rental property market.

1.3 Responsible Manager (signature and date):

Jess Rowe

Tax Strategy

Economic Systems Directorate

The Treasury

Jess Rowe

05/03/2021

Section 2: Problem definition and objectives

2.1 What is the current state within which action is proposed?

Access to affordable housing is important to support the living standards of New Zealanders

Housing supports many of the wellbeing domains identified in the Living Standards Framework, and plays a role in determining New Zealand's physical, social, and human capital stocks. High-quality housing stock provides shelter, protection from the elements, personal space, security, and privacy. Suitability, affordability, and quality of housing are likely to be influenced by housing affordability.

Affordable housing is an important factor in determining people's wellbeing, particularly for low-income families where housing costs represent a higher proportion of total income. High housing costs relative to income, poor housing quality and insecure tenure worsens child poverty, health outcomes and homelessness.[3] Renters generally live in poorer-quality housing that is more likely to be cold, damp, have mould, and need major repairs.

Home ownership in and of itself has long-term impacts on living standards and the distribution of wealth accumulation; New Zealand homeowners are typically 14 times wealthier than non-homeowners.[4] Furthermore, unaffordable housing disproportionately affects some population groups including low-income people, younger people, Māori, and Pacific peoples.

Housing affordability has been declining

Affordability for owner-occupiers

Housing costs compared to income are high in New Zealand compared to other OECD countries.[5] Nationally, house prices have been rising at a rate faster than wages over the past five years.[6] This trend has accelerated over the past year. House prices have increased 19.8 percent year-on-year to October 2020, with the median price at that time being $725,000.[7] Auckland's median house sale price for October was over $1 million for the first time.

Homeownership rates are significantly lower now than they were at their peak in the 1990s and, as at the 2018 Census, were at their lowest since the 1950s.[8] However, home ownership rates have remained relatively stable over the last 5 years, which may reflect first home buyers taking advantage of KiwiSaver deposits and low mortgage interest rates to enter the market. The decline from the 1990s in the proportion of households living in owner-occupied homes did not occur uniformly across the population and declined at a faster rate for Māori and Pacific peoples. For Māori the proportion of people living in an owner-occupied home declined across most of the 20th and early 21st century. Since 1991 it has fallen from 57.4% to 47.2% by 2018. For Pacific people it has dropped from 50.8% in 1986 to 35.1% in 2018.[9] There are also considerable disparities in homeownership rates by age, with homeownership rates higher for older people.[10]

Housing investors have consistently accounted for over one-third of property purchase transactions over the past decade, with investors making almost 40% of purchases in September 2020. Investor bidding is likely to exacerbate price escalation and hinder the ability of owner-occupiers to purchase houses.

3 Treasury analysis
4 Stats NZ, Housing in Aotearoa: 2020, pp 47. https://www.stats.govt.nz/assets/Uploads/Reports/Housing-in-Aotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf
5 OECD Better Life Index (2020). http://www.oecdbetterlifeindex.org/topics/housing/
6 Stats NZ, Housing in Aotearoa: 2020, pp 48, Figure 35. https://www.stats.govt.nz/assets/Uploads/Reports/Housing-in-Aotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf
7 REINZ Monthly Report October, pp 6. (Released 12 November 2020)
8 Stats NZ, Housing in Aotearoa: 2020.
9 Stats NZ, Figure 16 of Housing in Aotearoa: 2020.
10 Stats NZ, data from 1916-2018 Censuses. https://www.stats.govt.nz/news/homeownership-rate-lowest-in-almost-70-years

Affordability for renters

Housing unaffordability tends to be more pronounced for renters than owner-occupiers. In 2019, approximately one third of households were renters. This was more pronounced for lower income households with nearly half of all households in the lowest income decile renting. In 2020, 45% of renters spent 30% or more of their income on housing costs compared to 25% for owner-occupiers.[11] This high ratio of rents to incomes has been steady nationally for more than a decade. However, rents have grown much faster than incomes for some groups, including low-income renters, beneficiaries, and renters in major centres (such as Auckland and Wellington) and in some regions (such as Bay of Plenty, Taranaki and Gisborne). Several factors explain increasing rent prices including the cost to supply rentals and incomes.

The drivers of unaffordability are multifaceted and complex

Supply issues

Restrictions on the ability to increase housing supply in the short term mean that demand bids up the price of existing housing stock rather than contributing to greater housing construction in the short term. Such restrictions include regulatory barriers (e.g. zoning and height restrictions), increasing costs of building, and a lack of long-term infrastructure planning. Contributing to the lack of planning is local councils' limited access to financial capital.

As a result of these supply-side restrictions, increases in housing supply has not kept up with increases in demand over the last 40 years. Estimates of the shortage range between 40,000 and 130,000 houses.[12]

Demand issues

Demand side factors are also putting upward pressure on prices. Falling interest rates have resulted in an increase in house prices, creating capital gains for existing property owners but worsening the position of prospective first home buyers. The removal of loan to value ratio (LVR) restrictions by the Reserve Bank of New Zealand in response to COVID-19 allowed highly-leveraged investors to re-enter the market, exacerbating price pressures. High population growth has also increased demand for housing over recent decades.

While tax settings are not the primary driver of housing affordability, current tax settings incentivise investment in housing. In the context of constrained supply, lightly taxing housing relative to other forms of income will lead to higher property prices than would otherwise be expected.

11 Stats NZ, Housing in Aotearoa: 2020.

12 https://www.infometrics.co.nz/nz-short-by-nearly-40000-houses/ and Kiwibank analysis

2.2 What regulatory system(s) are already in place?

Taxation of residential rental housing

Income generated from renting residential houses is subject to income tax. That is, the gross rental less expenses (including interest) is taxed at the investor's marginal tax rate. Losses from rental property are ring-fenced, which means they can only be used to offset income from residential property, not the taxpayer's other income such as their salary and wages.

Taxation of capital gains from residential housing

There are a number of tax rules that determine whether the capital gains from the sale of property are taxable. For example, gains from the sale of residential property will be taxable if the purchaser acquired the property with the intention of disposing of it, or if they are engaged in regular property trading and/or development pattern.

A 5-year bright-line test for the taxation of residential investment property is already in place. The policy intent was that the bright-line period would act as a proxy for determining intent – that is, if someone purchases a property and disposes of it within a short period, it was likely that their intent when purchasing the property was to dispose of it.

For properties purchased on or after 1 October 2015 through to 28 March 2018 (inclusive), the bright-line rule applies to residential properties bought and sold within two years. Since 29 March 2018, any residential property bought and sold within five years is taxable.

The rule applies subject to some exemptions. The bright-line test does not apply to sales of the main residence (owner-occupiers). The only other exemptions are for inherited property and rollover relief for certain transfers of relationship property.

There are concerns about compliance with the existing bright-line test. Inland Revenue uses an analysis of Land Information New Zealand (LINZ) tax statement data compared to tax return information to approximate levels of compliance with the bright-line test.

Compliance levels are constantly changing as annual interventions are carried out including marketing, education, returns policing, direct mail-outs, community compliance visits and audits. From March 2021, all customers who have sold a residential property within the bright-line period will receive a letter advising them of their potential obligation and providing resources for them to assess their situation.

2.3 What is the policy problem or opportunity?

The cost of buying a house is placing significant financial stress on households and having perverse effects on equity (including intergenerational equity). House prices compared to income in New Zealand are high by international standards and have increased further over recent years. Rates of homeownership have declined significantly since the 1990s. As noted above, this impacts people's living standards.

The Government is also looking at a package of supply-side measures to address housing affordability in the long term. However, these measures will take some time to have an impact. To the extent that housing affordability concerns are due to excess demand and some of this demand is from investors, then reducing demand from investors may result in less upward pressure on house prices.

While the tax system is not the primary driver of housing affordability, features of the tax system exacerbate the issue. In particular, investment in housing is tax-preferred as compared to investments that do not earn large capital gains. This creates an incentive to invest in housing over other asset classes and puts further upward pressure on property prices.

2.4 What do stakeholders think about the problem?

The key stakeholders are: residential property investors / landlords, renters, first home buyers, owner-occupiers, other stakeholders with interests in macro-financial stability (including banks), non-government organisations and regulatory agencies. There are varying views from stakeholders as to the relative importance of supply side and demand side factors.

Due to time constraints, there has been no opportunity for consultation with external stakeholders on the proposal to extend the bright-line period or exempt new builds.

Inland Revenue and the Ministry of Housing and Urban Development have been involved in the development of this policy and were consulted in the preparation of this Regulatory Impact Statement. Their views are summarised below.

Inland Revenue view:

Inland Revenue recommended against both extending the bright-line and denying interest deductibility.

With the bright-line extension, a key concern is that many investors might pay substantial amounts of tax if they sold properties within 20 years but receive the gains tax free if they held the properties for longer period. Inland Revenue considered that this would have a substantial "lock-in effect" encouraging people to hold on to properties even if this would not otherwise be sensible. This is likely to impede property from being used in the highest value ways. Also, the 20-year extension is likely to add to compliance costs. Higher compliance costs and economic inefficiencies through lock-in effects might be viewed as a natural consequence of raising tax. But they are likely to be particularly inefficient if, often, no tax ends up being raised because properties are held for more than 20 years.

If this measure were to be introduced, Inland Revenue considers that there is a good reason to exempt new builds to minimise adverse impacts of the measures in reducing the supply of new housing.

However, Inland Revenue recommends that in the context of the bright-line test, the exemption should only be from the extension and not from the application of a bright-line test altogether. Such properties are currently subject to the 5-year bright-line test under the status quo and building consents are at an all-time high. A full exemption would create an incentive for speculation in the market for new builds, placing further upward pressure on prices. There are further administrative concerns as it would increase reliance on other aspects of the land sale rules in the Income Tax Act, including the intention test, which is subjective in nature and difficult to administer for a large group of taxpayers.

Ministry of Housing and Urban Development view:

The Ministry of Housing and Urban Development supports either a full exemption or a partial exemption (ie, existing 5 year bright-line continues to apply) from the extended bright-line test for new builds to mitigate the impact on the new supply of housing. Maintaining and increasing new supply is critical to addressing housing affordability in the medium term. The Ministry is concerned about the potential impact that extending the bright line test could have on demand for new builds, construction sector jobs, and decreased investor willingness to invest in Build to Rent.

In the absence of clear information about the effectiveness of an exemption, the Ministry of Housing and Urban Development would err on the side of supporting new supply and the continued growth in construction jobs which has partially offset job losses in other sectors and supported the economic recovery.

2.5 What are the objectives sought in relation to the identified problem?

As noted on 15 February 2021 (CAB-21-MIN-0018 refers), Cabinet's policy objectives for the housing market are to:

- Ensure every New Zealander has a safe, warm, dry, and affordable home to call their own – whether they are renters or owners.
- Support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers.
- Create a housing and urban land market that credibly responds to population growth and changing housing preferences, that is competitive and affordable for renters and homeowners, and is well-planned and well-regulated.

The intervention identified in this Regulatory Impact Statement seeks to address the Government's demand-side housing objectives as set out in the second bullet point above: to support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers.

One interaction between these objectives is that more supply will support affordable housing for all New Zealanders, including first-home buyers, in the long-term. This interaction is considered in this Statement.

Section 3: Option identification

3.1 What options are available to address the problem?

The status quo is to retain current tax settings for residential housing, including applying the bright-line test to properties sold within 5 years.

The Government has identified three policy options, each with three sub-options, to be considered:

- **Option 1: Extending the bright-line period to 20 years for property acquired on or after the application date:** This option would extend the period in which properties sold could be subject to the bright-line test from 5 years to 20 years. The test would still not apply to a person's main home. There are also further options relating to new builds[13]:
    - **Option 1A:** no exemption for new-builds:
    - **Option 1B:** applying a 5-year bright-line test to new-builds:
    - **Option 1C:** completely exempting new-builds from the bright-line test:

13 A new-build exemption would apply to early investors in newly-built housing (any purchaser up to 12 months after the council code compliance certificate is issued under the Building Act 2004) from the extension.

- **Option 2: Extending the bright-line period to 15 years for property acquired on or after the application date:** This option would extend the period in which properties sold could be subject to the bright-line test from 5 years to 15 years. The test would still not apply to a person's main home. There are also further options relating to new builds:
  - **Option 2A:** no exemption for new-builds:
  - **Option 2B:** applying a 5-year bright-line test to new-builds:
  - **Option 2C:** completely exempting new-builds from the bright-line test:
- **Option 3: Extending the bright-line period to 10 years for property acquired on or after the application date:** This option would extend the period in which properties sold could be subject to the **bright**-line test from 5 years to 10 years. The test would still not apply to a person's main home. There are also further options relating to new builds:
  - **Option 3A:** no exemption for new-builds:
  - **Option 3B:** applying a 5-year bright-line test to new-builds:
  - **Option 3C:** completely exempting new-builds from the bright-line test:

There are further decisions to be made about application dates. These do not make a material difference to the analysis as the difference in dates is only a matter of days. There are further technical options to amend the bright-line test (such as the scope of exclusions) that are not assessed in this Regulatory Impact Statement.

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 likely impacts of the proposals have been assessed against a set of criteria to evaluate the impact of the proposals on the Government's demand-side objectives (above at 2.5), the effect on rental affordability, and traditional tax policy criteria of efficiency, integrity, equity, revenue, compliance and administration costs, and coherence, as below:[14]

- **Efficiency and growth:** Taxes should be, to the extent possible, efficient and minimise as far as possible impediments to economic growth. That is, the tax system should avoid unnecessarily distorting the use of resources (e.g. causing biases toward one form of investment versus another) and imposing heavy costs on individuals and firms.
- **Equity and fairness:** The tax system should promote fairness. The burden of taxes differs across individuals and businesses depending on which bases and rates are adopted. Assessment of both vertical equity (the relative position of those on different income levels or in different circumstances) and horizontal equity (the consistent treatment of those at similar income levels, or similar circumstances) is important.
- **Revenue integrity:** The tax system should be sustainable over time, and minimise opportunities for tax avoidance and arbitrage.
- **Fiscal impact:** Tax reforms need to be affordable given fiscal constraints, and the tax system must raise sufficient revenue to support the Government's fiscal strategy.

14 Victoria University Tax Working Group, 2010, p. 15.

- **Compliance and administration cost:** The tax system should be as simple and low cost as possible for taxpayers to comply with and for the Inland Revenue Department to administer.
- **Coherence:** Individual reform options should make sense in the context of the entire tax system. While a particular measure may seem sensible when viewed in isolation, implementing the proposal may not be desirable given the tax system as a whole.

The trade-offs between the different criteria are discussed in detail below.

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

The analysis is limited by the tax options already ruled out by the Government, including a comprehensive capital gains tax, a tax on a deemed rate of return for residential property, a wealth tax, or any new measure outside of the current tax framework.

The Government has set out that it intends to bring forward a broader range of supply-side measures.

Section 4: Impact Analysis

Marginal impact: How does each of the options identified in section 3.1 compare with taking no action under each of the criteria set out in section 3.2?

	No action	**Option 1A** 20 year BL and no new build exemption	**Option 1B** 20 year BL and 5yr BL for new builds	**Option 1C** 20 year BL and full new build exemption	**Option 2A** 15 year BL and no new build exemption	**Option 2B** 15 year BL and 5yr BL for new builds	**Option 2C** 15 year BL and full new build exemption	**Option 3A** 10 year BL and no new build exemption	**Option 3B** 10 year BL and 5yr BL for new builds	**Option 3C** 10 year BL and full new build exemption
Support greater housing affordability for first home buyers	**0**	**0 / +**	**0 / +**	**0**	**0 / +**	**0 / +**	**0**	**0 / +**	**0 / +**	**0**
Dampening investor demand for existing housing stock	**0**	**+**	**+**	**+**	**+**	**+**	**+**	**0 / +**	**+**	**+**
Improve affordability in the rental market	**0**	**-**	**- / 0**	**0**	**-**	**- / 0**	**0**	**-**	**- / 0**	**0**
Efficiency and growth	**0**	**+**	**0 / +**	**-**	**0**	**0**	**-**	**-**	**-**	**-**
Equity and fairness (horizontal and vertical)	**0**	**+**	**0 / +**	**-**	**+**	**0 / +**	**-**	**+**	**0 / +**	**-**
Integrity	**0**	**+**	**0 / +**	**-**	**+**	**0 / +**	**-**	**+**	**0 / +**	**-**
Revenue impact	**0**	**+**	**0 / +**	*****	**+**	**0 / +**	*****	**+**	**0 / +**	*****
Compliance and administration costs	**0**	**-**	**- -**	**0**	**-**	**- -**	**0**	**-**	**- -**	**0**
Coherence	**0**	**+**	**0 / +**	**-**	**+**	**0 / +**	**-**	**+**	**0 / +**	**-**
Overall conclusion	**0**	**+**	**0**	**-**	**0 / +**	**0**	**-**	**0**	**0**	**-**

Key:

++	much better than doing nothing/the status quo	-	worse than doing nothing/the status quo
+	better than doing nothing/the status quo	- -	much worse than doing nothing/the status quo
0	about the same as doing nothing/the status quo	*	Overall impacts depend on further analysis and more detailed design

Option 1A: Extending the bright-line period to 20 years for property acquired on or after the application date (no new-build exemption)

Support greater housing affordability by putting downward pressure on house prices

Extending the bright-line period to 20 years would increase the tax cost of investment property compared with the status quo. All else being equal, this would put downward pressure on demand and therefore on property prices. This would benefit first home buyers, especially current renters with higher incomes. Due to the lack of robust empirical evidence or models, this impact cannot be quantified.

House prices continued to rise at the same time as the bright-line test was introduced in 2015 and extended in 2018, however it is not possible to determine whether they would have increased more in the absence of those policy changes or the extent of the impact that the bright-line test may have had. It is difficult to predict the impact of a much lengthier extension.

Existing property owners could be negatively impacted if the policy results in house prices being lower than they would have been otherwise. Due to the lack of empirical data, this impact cannot be quantified.

The price impact could be moderated in the long run as there could be a reduced incentive to build new houses. The impacts on long-run supply from this measure may be small as the supply of new houses is currently limited by regulatory, infrastructure and sector capacity constraints, and there is excess demand for new houses. Given the complexity and dysfunction in the housing market, the impact of demand-side tax measures on the long-run supply of new houses is complex and uncertain.

Dampening investment demand for existing housing stock

Extending the bright-line test to 20 years would increase the expected tax paid by property investors, compared with the status quo, and therefore would discourage residential property investment (including for new builds). However, the impact on residential property investors' is strongly dependent on the behavioural responses and on the availability of higher-yielding alternative investment options. It may also encourage potential investors to increase their investment in their main home, the gains from which will remain tax-free.

Improve affordability in the rental market

There is potential for an extension to the bright-line test to reduce investor demand for new rental supply, compared with the status quo. Even if there were no long-run reduction in new builds, the bright-line extension may potentially put upward pressure on rents as some of the increase in tax may be passed onto renters either directly (through higher rents) or through a reduction in rental supply as fewer properties are purchased by investor landlords in the future.

Alternatively, to the extent that rents are set by income levels, they may not significantly increase as a result of this policy. However, as noted above, this depends on behavioural responses and features of the rental market.

If this policy were to result in increased rents and reduced rental supply, it could impact on living standards if tenants spend a large proportion of their income on housing. Specifically, rent to income ratios may increase, or tenants could be forced to live in premises that are not suitable for the occupants or the number of occupants, and in extreme cases, could cause homelessness. Higher rents would decrease financial, social, and human capital stocks for renters. In this context, financial capital refers to the accumulation of assets by the person. Social capital refers to the social connections that contribute to societal wellbeing by promoting coordination and collaboration between people and groups in society. The more secure a person's housing is, the more likely they are to make those connections. Human capital includes health, which could be negatively affected by additional crowding.

To the extent that proposals place upward pressure on rents, this appears more likely to disproportionately impact low-income households, younger people, Māori, and Pacific peoples, who are less likely to own their home relative to the general population. In addition, as around 43% of children are living in rental accommodation, upward pressure on rents could have negative impacts on child wellbeing and child poverty. Increases in rents may also lead to an increase in spending on the accommodation supplement and temporary additional support although it is difficult to quantify this impact at this stage.

Efficiency

Taxing more economic income

Taxing more capital gains through extending the bright-line period could have efficiency benefits by ensuring that more economic income is taxed. In other words, it would bring the taxation of investment in residential properties more in line with the taxation of other investment income that does not earn capital gains, such as interest income. This could improve allocative efficiency to the extent there is more consistent taxation between residential property and some other investment classes. This means investors will be making choices on the basis of actual differences in returns between assets, rather than one generated by tax advantages.

However, in line with the status quo, it would not apply to many other gains, including those on listed shares, agricultural land, commercial or industrial property, or to the sale of businesses. Because it would apply to gains on only one category of property (albeit a very high value category), it would have smaller potential efficiency gains than a comprehensive capital gains tax.

Lock-in impacts of extending the bright-line period

Extending the bright-line test would extend the 'lock-in' effect for properties held for a longer period, compared with the status quo. However, there could be competing effects on lock-in from extending the bright-line test, provided the extension is for a sufficiently long period (discussed below).

The lock-in is the incentive for residential property investors to hold property for longer to avoid the tax liability. This potentially has economic costs, as it may discourage people selling property to others who may put it to more productive use, such as housing intensification or a higher utilisation rate. It may also impact the allocation of investment as individuals may retain rental properties even when they wished to change investments, such as starting a new business.

Lock-in, a discouragement to sell, already arises with the current 5-year bright-line test ("the status quo"). In determining the impact of extending the bright-line period, data on the holding period for residential property has been considered:

Table 1. Holding period for residential property sold in 2017

Holding period	**2 years or less**	**5 years or less**	**10 years or less**	**15 years or less**	**20 years or less**
Percentage of property sold	18%	42%	64%	83%	91%

Source*: Corelogic data prepared for the Tax Working Group*

Note: This data includes residential property sold by owner-occupiers as well as investors. The data excludes property which Corelogic could not determine a holding period for (which may be a result of it being held for a very long period of time which could mean the results understate the average holding period). This data is for properties classified as either residential or lifestyle.

This data should be seen as indicative only as it includes both owner-occupied and rental properties and excludes some sales. The median holding period for residential property is approximately 7-8 years. Around 40% of properties sold were held for 5 or fewer years and around 90% of properties sold were held for 20 or fewer years.

While in principle a bright-line test of any length will have lock-in effects that will result in some economic distortions, there will be a point at which the timeframe is so long (e.g. a period of 999 years) that it will be effectively indefinite. At this point the lock-in effects will be lower than a shorter bright-line period, as the cost of waiting out the test will be too high for most owners. As a result, extending the bright-line period sufficiently can reduce the overall lock-in effect.

There are, however, competing effects from a moderately longer test and it is not possible to determine the length at which lock-in will be minimised.

On the one hand, the lock-in effects become much more potent if capital gains are a large fraction of the value of an asset. As a result, an extension of the bright-line test to 20 years would make it much more common for assets to have generated substantial taxable capital gains and be subject to high levels of tax when they were sold. A longer bright-line period, like 20 years, will have a much stronger lock-in effect than the current 5-year test, for the subset of properties that are held for a lengthy period.

However, a longer test may encourage more investors who wish to hold for shorter periods to sell within the bright-line period as compared to a shorter test. For example, compared to the status quo, a longer test may encourage more sales within 5 years, when investors would have otherwise waited out the 5-year period. This is because they would have to wait a very long time in order to not pay the tax under a longer test. The bright-line period would need to be relatively long (e.g. 20 years) to provide sufficient discouragement to 'waiting out the period' for individuals whose preference is to sell in a short period of time.

As noted previously, there is not good empirical evidence on which to assess these impacts. The data does suggest, however, that a significant number of houses are sold before 10 years, so reducing lock-in for these sales may well have a benefit.

In any event, it is likely that the lock-in impact will not significantly affect the utilisation rate of existing housing stock. This is because, in many cases, the property would continue to be put to the same or similar use by a different owner, meaning that a delay in sale would not result in a less productive use of the asset. For example, where a rental property is sold, it is likely to be sold for continued use as accommodation for renters or owner-occupiers.

In some cases, lock-in may prevent sales to developers who may have intensified the use of the land when existing investors would not. However, while lock-in may delay intensification, this would not be a long term impact as lock-in only delays the sale.

A concern is whether lock-in would make it relatively unattractive for taxpayers to sell little-used second homes for lengthy periods of time and whether this would significantly detract from the supply of main homes. This will depend on the extent to which such homes (e.g. holiday homes) are in areas sufficiently close to major working centres for them to be acquired by owner-occupiers or by landlords for rental housing. There is limited data to determine this impact. However, it is considered that not all second homes, such as baches, could be converted to primary residences due to their location, and hence a delay in selling these houses would not have much impact on the supply of primary residences in economic centres. In addition, little-used second homes are likely to form only a relatively small part of the overall housing stock.

Accordingly, on balance, we do not expect the lock-in effect to have a significant impact on housing utilisation compared with the status quo. While lock-in may delay investors exiting investments to undertake higher value investments, a prospective rule would only apply to new investments. Therefore, investors will factor in these considerations (long term expected return and holding period) when they enter the investment.

Revenue integrity

Extending the bright-line test will enhance the integrity of the tax system to the extent it minimises opportunities for tax avoidance and arbitrage.

This is because the extended bright-line period would cover the majority of property transactions involving non-owner-occupied residential properties, and thus reduce the ability to rely on the exclusions from the existing complex suite of land tax rules. There are existing integrity rules that apply to the current 5 year bright-line test that will carry over to the extension (for example, to deal with land-rich companies). It will be important to buttress the extended test with appropriate administrative action (see below).

As discussed, an extended test may increase the incentive to avoid the bright-line test for properties held for long periods through delaying sales as the gains are potentially large (lock-in).

Equity

Extending the bright-line period would extend the taxation of gains from a particular type of property – non owner-occupied residential property. This would enhance horizontal equity in relation to income from salary and wages, which is fully taxed. In contrast, capital gains derived from the sales of businesses or some other assets would continue to not be taxed (as under the status quo).

Some of those with second homes or rental property who sell within the bright-line period could be taxed on much of their gain at 39%, even if their normal levels of income are much lower than $180,000.[15] This is because gains that have accrued over many years would be taxed in a single year. This could be seen as unfair when many other types of gains including gains on listed shares, on agricultural land, on commercial or industrial property or on the sales of businesses would continue not to be taxed. However, payment of tax on the gain will be delayed until sale of the property, giving taxpayers a benefit in that tax is delayed compared to when income was earned.

Increasing the tax rate on capital would likely be progressive (since capital income from selling residential investment properties tends to be earned disproportionately by those on higher incomes), so would improve vertical equity.[16]

[15] The tax paid on the sale of property may be delayed or reduced if they are held in trusts or companies.

[16] See Net Worth of residential (rental) real estate, *Household expenditure statistics 2018*, Statistics NZ.

Fiscal impact

Extending the bright-line test will raise revenue. Inland Revenue has a static model to predict possible revenue arising from a 20 year bright-line extension. However, the precise sum of revenue raised will depend on investors' behavioural responses that we are unable to model.

Behavioural responses might include restructuring house ownership to lower marginal tax rates or increased rates of sales by investors who have determined they cannot wait 20 years. These effects will impact our estimates but cannot be modelled with any level of confidence.

The static model predicts that there will be no new revenue over the forecast period, as any sales in this period would be captured by the existing 5 year bright-line test. The static model suggests that an extended 20 year bright-line will start generating revenue in 2029. On the assumption of no behavioural changes, the sums generated should increase over time and could reach around 0.2% of GDP in annual revenue in 2035, depending on the behavioural responses of investors.

There are many assumptions underlying this estimate, including assumptions on the distribution of ownership, the average gain on sale and how this might change over time, the volume of sales, the probability an exemption is claimed, and the share of sales already taxable under other provisions. These assumptions have a direct impact on the estimated fiscal gain. More importantly, we expect the lock-in effect to dampen any potential fiscal gains, particularly in the longer term.

Compliance and administration costs

The bright-line extension could impose some compliance costs on relatively unsophisticated taxpayers. For example, taxpayers (including those with second homes) will often make some capital improvements to a property over a 20-year period. It can be complicated to distinguish capital improvements from repairs and maintenance. Taxpayers will be required to keep records of capital improvements for 20 years because money spent on capital improvements can only be deducted from a gain on sale.[17] This may mean that taxpayers would have to keep records of improvement costs for 20 years, even if the property is ultimately held for more than 20 years.[18]

To implement the extension to the bright-line period, there will be administration costs to Inland Revenue and LINZ to the extent updates are required to the relevant forms, systems and guidance.

Coherence

Extending the bright-line broadens the tax base by taxing more economic income. To that extent, it enhances the coherence of the tax system compared to the status quo. However, it would result in a variety of rules taxing capital gains, which would be less coherent than a comprehensive capital gains tax.

Overall conclusion

On balance, the Treasury recommends this option. The extension will help meet some of the Government's housing market objectives. Extending the bright-line test should put downward pressure on house prices in the short to medium term, and provide equity and efficiency benefits as more economic income is taxed. Conversely, extending the bright-line test may put upward pressure on rents and have potential lock-in effects (although the additional costs

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17 Repairs and maintenance expenses can be deducted against rental income.

18 Officials intend to review what costs are deductible under the bright-line test.

of these are unclear, and the Treasury's view is that lock-in will not significantly reduce housing utilisation).

Option 1B: Extending the bright-line period to 20 years for property acquired on or after the application date – excluding new builds (applying a 5-year bright-line to new-builds)

Extending the bright-line test would put downward pressure on property prices, but in doing so may reduce incentives to build new houses. A reduction in supply, compared to without the tax, would mitigate somewhat any reduction in house prices arising from the tax over the longer term. Data from CoreLogic shows that almost 40% of new build properties were purchased by multiple-property owners (a proxy for investors) in 2020. One option to mitigate the reduced incentive to build is to exclude new housing from the bright-line extension. This would mean that the 5-year bright-line period would still apply to new builds.

This option will have the same costs and benefits as Option 1A, but on a smaller scale and with additional further compliance and administrative costs. The analysis below focuses on the differences in the impacts of these options.

Support greater housing affordability by putting downward pressure on house prices

Compared to applying the extended bright-line test to all properties, special rules for new builds would lead investors to demand more new build properties (as opposed to existing dwellings), as they attract a significant tax advantage. That, in turn, means that the price of new builds is likely to be higher than without the exemption, which will mean that buyers who do not have a tax advantage (e.g. owner-occupiers) will tend to shift their demand to existing stock (particularly if they are priced out of market for new builds). There could be an impact on supply to the extent that it increases greenfield development or intensification. Over the long term any increased supply will put down pressure on prices. The overall impact of those offsetting shifts in the long run are unclear, and depend on the exemption's design, but intuition suggests that any impact of the tax changes on house prices, supply, or rents will be smaller than without an exemption.

Dampening investment demand for existing housing stock

A new build exemption could potentially reduce investment in existing property, as compared to either the status quo or having no exemption from the tax proposals, as new build properties would be at a tax advantage. Investor demand for new builds would not be expected to be reduced compared to the status quo.

Improve affordability in the rental market

Costs for investors in new builds would be lower with an exemption, and supply may be higher than without an exemption. This could suggest any potential increase in rents for new builds would be lower than for existing dwellings, but equilibrium prices for the whole rental market would likely prevail. As a result, there may be upward pressure on rents as compared to the status quo, but lower than without an exemption. The scale of this is uncertain and depends on the behavioural responses of the investors and owner-occupiers. This would mitigate some of the potential negative living standards impacts from the bright-line extension.

Efficiency

Excluding new builds would reduce the efficiency benefits of Option 1A, as capital gains on new builds purchased by early investors would remain relatively lightly taxed and out of line with other investment income. The Treasury considers there are likely to be more efficient ways to directly support supply, for example through an explicit subsidy for developers.

Equity

The impacts of the exemption reduce the equity impacts of the extension of the bright-line. Specifically, extending the bright-line test improves horizontal equity because more economic income is taxed; exempting some of this income means less is taxed which has a lower impact on horizontal equity. There is a similar effect for vertical equity considerations.

Integrity

Providing an exemption for new builds would likely be difficult to apply in practice and could open opportunities for tax avoidance.

Compliance costs and administration costs

A new build exemption would create complexity and compliance costs for taxpayers, and administrative costs for Inland Revenue

Revenue impact

Providing an exemption for new builds would reduce the revenue that the Government would otherwise receive under the bright-line extension. It has not been possible in the tight timeframe to estimate the quantum of the revenue impact of the exemption.

Coherence

The new build exemption would reduce the coherence of the tax system by creating a distortion in the types of economic income that is taxed. The exemption would not be based on established tax principles.

Overall conclusion

The Treasury does not support a new build exemption. The Treasury considers there are likely to be better ways to directly support supply, for example through an explicit subsidy for developers. In addition to the challenges set out above, the Treasury considers it would be very difficult to amend or remove an exemption in the future if further analysis concluded that alternative measures achieved a similar outcome at lower cost.

Option 1C: Extending the bright-line period to 20 years for property acquired on or after the application date – completely excluding new builds from the bright-line test

This option will have similar costs and benefits as Option 1A for existing dwellings. However, completely excluding new builds from the bright-line test will reduce the taxation of such properties compared with the status quo (as such properties are currently subject to the 5 year bright-line test). The analysis below focuses on the differences in the impacts of these options for newly-built houses.

Support greater housing affordability by putting downward pressure on house prices

Excluding new builds from the bright-line test altogether may encourage investment in newly-built residential property relative to other higher taxed investments e.g. bank deposits. It is also likely to encourage property investors to purchase new builds instead of existing housing. The effect of this is multidirectional. Greater demand for new builds could increase housing supply over the longer term. To the extent this eventuates, this could put downward pressure on house prices in the long-run. However, exempting new builds from the bright-line test decreases the tax cost of this type of investment property compared to the status quo. This could put upward pressure on demand for new builds and increase the amount investors are willing to pay, and therefore the price of new builds.

The net impact of these effects is unclear. There is a risk this could negatively impact first home buyers wishing to purchase new build properties and shift owner-occupier demand into the existing stock (which may be lower quality). Due to the lack of robust empirical evidence or models, these impacts cannot be quantified.

Dampening investment demand for existing housing stock

As noted above, exempting new builds from the bright-line test altogether is likely to encourage investors to purchase new residential properties instead of existing residential properties. This is likely to reduce investor demand for existing stock. However, the quantum would depend on property investors' behavioural responses and broader supply constraints.

Improve affordability in the rental market

Exempting new builds could increase investor demand for new rental supply, compared with the status quo. In the short-term, an exemption could potentially put downward pressure on rents to the extent that the decrease in tax is passed onto renters. However, as noted above, this depends on behavioural responses and features of the rental market. Alternatively, to the extent that rents are set by income levels, they may not decrease as a result of this policy.

Over the long-term, an exemption could put downward pressure on rents, to the extent it encourages an increase in long-run supply through greenfield developments and intensification.

If this policy were to result in decreased rents and increased rental supply, it would improve living standards. Lower rents would increase financial, social, and human capital stocks for renters. This is likely to specifically benefit low-income households, younger people, Māori, and Pacific peoples, who are less likely to own their home relative to the general population. In addition, any reduction in rents and increase in rental supply is likely to benefit child wellbeing and reduce child poverty.

Efficiency

Taxing more economic income

Exempting new builds from a bright-line test would reduce the efficiency of the tax system by reducing economic income that is taxed, relative to the status quo. It would also negatively impact allocative efficiency by increasing the tax bias towards investing in newly-built residential property as opposed to existing housing or other investments, such as bonds.

Lock-in impacts

Exempting new builds from any bright-line test would fully mitigate the lock-in effects for new build property compared with the status quo.

Equity and fairness

Exempting new builds from the bright-line test would reduce the taxation of gains from newly-built residential properties. This would reduce horizontal equity in relation to income from salary and wages, which is fully taxed. Decreasing the tax rate on capital would likely be regressive (since capital income from selling residential investment properties tends to be earned disproportionately by those on higher incomes)[19], so would decrease vertical equity.

19 See Net Worth of residential (rental) real estate, *Household expenditure statistics 2018*, Statistics NZ.

Revenue integrity

Creating an exemption for new builds would reduce the integrity of the tax system. It could create incentives and opportunities to avoid taxation on the capital gains from residential property investment. It could mean a greater reliance on the other land sale rules in the Income Tax Act that have been difficult to apply in practice, such as the intention test. Even with improvements in information and reporting requirements since the introduction of the original bright-line test, there would still be practical difficulties in relying on a subjective rule like the intention test for a large group of taxpayers.

Fiscal impact

Exempting new builds from the bright-line test altogether would result in forgone revenue within the forecast period and out-years. However, officials have not had sufficient time to quantify this foregone revenue.

Compliance and administration costs

The proposed exemption would reduce the compliance costs for new-build residential investors who would no longer need to file a tax return or keep records to establish deductions under the bright-line test.

However, it would create some compliance costs for investors as they would have to prove the relevant property satisfied the requirements to be a new build.
Exempting new builds from the bright-line test is likely to put more pressure on the other land sale rules in the Income Tax Act. This is likely to increase the administration costs for Inland Revenue (e.g. utilising the intention test is more resource intensive than applying the bright-line test). As the intention test is subjective in nature, there would be practical concerns with actively relying on such a rule for a large group of taxpayers. Where an investigation is opened to determine whether the intention test applies, this would also create compliance costs for taxpayers.

Coherence

Excluding new builds from the bright-line test would reduce the coherence of the tax system by excluding economic income from the tax base. Further, it would create an additional distinction not based on taxation principles.

Overall conclusion

On balance, the Treasury does not support excluding new builds from the bright-line test altogether. The exemption would reduce the effectiveness of the extension in achieving the Government's objective of supporting first home buyers by reducing any downward pressure on property prices and having a lesser impact on investor demand. However, it could reduce the extent of any upward pressure on rents. It could reduce the efficiency of the tax system by reducing economic income that is taxed. It could reduce the fairness and integrity of the tax system, and would have a fiscal cost. If the Government wishes to pursue an exemption, the Treasury prefers that exempt properties be subject to the 5 year test.

Option 2A: Extending the bright-line period to 15 years for property acquired on or after the application date (no new-build exemption)

Support greater housing affordability by putting downward pressure on house prices

Extending the bright-line period to 15 years would likely increase the tax imposed on many investment properties compared with the status quo. It would increase the tax imposed less than a 20-year period, but more than a 10-year period. Available data suggests that around

80% of properties are currently sold within a 15 year holding period at present.[20] This proportion may reduce if the bright-line period were extended to 15 years, as more investors are likely to hold beyond 15 years to avoid the tax liability.

While a 15 year bright-line period would put downward pressure on demand and therefore on property price inflation, it is likely to have less of an impact than a 20-year period. The benefit to first home buyers, therefore, could be less than a 20-year period. Due to the lack of robust empirical evidence or models, the difference in impacts cannot be quantified.

The increased tax could have less of a long-run impact on supply than an extension to 20-years. However, as noted above, given the complexity and dysfunction in the housing market, the impact of demand-side tax measures on the long-run supply of new houses is complex and uncertain.

Dampening investment demand for existing housing stock

Similar to Option 1A, extending the bright-line period to 15 years would likely reduce investor demand for investment property (including new builds) but to a lesser extent.

Improve affordability in the rental market

Extending the bright-line period to 15 years has the potential to reduce investor demand for new rental supply, compared with the status quo. However, it is likely to have less of an impact than for a longer bright-line test. The increased tax liability may be partially passed onto renters, however this will be less than for a longer test. This suggests that an extension to 15 year may put upward pressure on rents, which would negatively impact on renter's living standards, but this is likely to be less than with a 20-year bright-line period.

Efficiency

Taxing more economic income

Extending the bright-line period to 15 years would increase the amount of economic income that is taxed compared to the status quo. This would improve allocative efficiency, but not as much as a 20-year period.

Lock-in impacts of extending bright-line period to 15 years

Extending the bright-line period to 15 years would increase the lock-in effect for properties held for a longer period than the status quo. As noted above, there are competing effects on lock-in from different bright-line periods.

A 15-year period may be sufficiently long to discourage many investors from holding onto property to wait out the holding period. However, the accumulated capital gains might become a large fraction of the value of asset over a 15-year period, encouraging investors to hold onto the property. There is not good data to help with determining the relative impacts of the different effects described above.

In any event, as noted above, it is likely that the lock-in will not reduce housing supply through low utilisation of the existing housing stock. This is because, in many cases, the property would continue to be put to the same or similar use by a different owner, meaning that a delay in sale would not result in a less productive use of the asset.

20 Subject to the limitations discussed in relation to table 1.

Equity

Extending the bright-line period to 15 years would extend the taxation of gains from non-owner-occupied residential property, compared with the status quo. This would enhance horizontal equity in relation to income from salary and wages, which is fully taxed. It would not enhance horizontal equity as much as a 20-year bright-line period.

As discussed above, increasing the effective tax rate on capital would likely be progressive (since capital income from selling residential investment properties tends to be earned disproportionately by those on higher incomes),21 so would improve vertical equity compared with the status quo. However, it would not improve vertical equity as much as a 20-year bright-line period.

Revenue integrity

Extending the bright-line test to 15 years would enhance the integrity of the tax system to the extent it minimised opportunities for tax avoidance and arbitrage. A 15-year period would increase the proportion of residential property transactions that are covered by the test, so it would reduce the ability of land owners to rely on the exclusions to the existing set of complex land rules.

Fiscal impact

Having a bright-line period of 15 years would raise more revenue than the status quo and a 10-year period, but less than a 20-year bright-line test. However, the precise revenue raised will depend on investors' behavioural responses that we are unable to model.

Compliance and administration costs

The additional compliance and administration costs are likely to be greater than the status quo and a 10-year period, and are likely to be similar to a 20-year period.

Coherence

Extending the bright-line period to 15 years would broaden the tax base by taxing more economic income, but less so than a 20-year period. To that extent, it enhances the coherence of the entire tax system compared to the status quo.

Overall conclusion

On balance, this is not the Treasury's preferred option. However, the Treasury recommends it over the status quo. The extension will help meet some of the Government's housing market objectives - but not to the same extent as a 20-year extension. Extending the bright-line test would put downward pressure on house prices in the short to medium term, and provide equity and efficiency benefits as more economic income is taxed. Conversely, extending the bright-line test may put upward pressure on rents and have potential lock-in effects (although the additional costs of these are unclear, and the Treasury's view is that lock-in will not significantly reduce housing utilisation).

Options 2B and 2C: Extending the bright-line period to 15 years for property acquired on or after the application date with exemptions for new builds

Providing either a full or partial exemption for new builds from a 15 year bright-line extension would have similar impacts to Options 1B and 1C.

21 See Net Worth of residential (rental) real estate, *Household expenditure statistics 2018*, Statistics NZ.

Option 3A: Extending the bright-line period to 10 years for property acquired on or after the application date (no new-build exemption)

Support greater housing affordability by putting downward pressure on house prices

Extending the bright-line period to 10 years would likely increase the tax imposed on some investment properties compared to the status quo. However, it would increase the overall tax imposed by less than a longer extension. Available data suggests that around two-thirds of properties are currently sold within 10 years, although this figure may reduce substantially under a 10 year bright-line test.

While a 10 year bright-line period would put downward pressure on demand and therefore on property price inflation, it would have less of an impact than a longer period. The benefit to first home buyers, therefore, would be less than a longer extension. Due to the lack of robust empirical evidence or models, this impact cannot be quantified.

In contrast, the lower overall tax cost could have less of a long-run impact on supply. However, as noted above, given the complexity and dysfunction in the housing market, the impact of demand-side tax measures on the long-run supply of new houses is complex and uncertain.

Dampening investment demand for existing housing stock

Extending the bright-line period to 10 years may reduce investor demand for investment property (including new builds).

Improve affordability in the rental market

Extending the bright-line period to 10 years has the potential to reduce investor demand for new rental supply, compared with the status quo. However, it is likely to have less of an impact than a longer bright-line period. The increase in tax liability will be smaller than for a longer period. This suggests that an extension to 10 years may put some upward pressure on rents, which would have negative impacts on renter's living standards, but this is likely to be less than with a longer bright-line period.

Efficiency

Taxing more economic income

Extending the bright-line period to 10 years would increase the amount of economic income that is taxed compared to the status quo, but not as much as a longer period. This would improve allocative efficiency compared with the status quo but not as much as a longer period.

Lock-in impacts of extending bright-line period to 10 years

Extending the bright-line period to 10 years would create lock-in for properties held for 5-10 years. Under the status quo (5 years), there is currently no lock-in for the properties held for more than 5 years. As noted above, there are competing effects on lock-in from different bright-line periods and it cannot be determined whether a 10, 15 or 20-year test would have the greatest lock-in.

Compared to a 20-year test, a 10-year test may not significantly reduce lock-in for properties intended to be held for short periods, as many individuals will be willing to wait out a 10-year test. Based on the data discussed above, around two thirds of properties are currently sold before 10 years and may be subject to lock-in under a 10-year test. However a 10-year test will not give rise to lock-in for properties held between 10 and 20 years, and as the tax liability will be lower at 10 years than 20 years, the lock-in effect will be lower approaching 10 years than 20 years.

Equity

Extending the bright-line period to 10 years would extend the taxation of gains from non-owner-occupied residential property, compared with the status quo. This would enhance horizontal equity in relation to income from salary and wages, which is fully taxed. However, it would not enhance horizontal equity as much as a longer bright-line period.

Increasing the tax imposed on capital income would likely be progressive (since capital income from selling residential investment properties tends to be earned disproportionately by those on higher incomes), so would improve vertical equity compared with the status quo.[22] However, it would not improve vertical equity as much as a longer bright-line period.

Revenue integrity

Extending the bright-line period to 10 years would enhance the integrity of the tax system to the extent it minimises opportunities for tax avoidance and arbitrage. It would extend the range of property transactions covered by the rule, compared with the status quo. However, more transactions would be subject to the other land rules (with their complexities and exclusions) than under a longer bright-line period.

Fiscal impact

Having a bright-line period of 10 years would raise more revenue than the status quo, but less than a longer bright-line period. However, the precise revenue raised will depend on investor's behavioural responses that we are unable to model

Compliance and administration costs

The additional compliance and administration costs are likely to be greater than the status quo, but less than a longer bright-line period.

Coherence

Extending the bright-line period to 10 years would tax more economic income than the status quo, but less than a longer period. It would enhance the coherence of the tax system but less than a longer period. Compared to a comprehensive capital gains tax, having multiple mechanisms to tax capital gains would be less coherent.

Overall conclusion

On balance, the Treasury would prefer an extension of the bright-line test for a period longer than 10 years. Extending the bright-line period to 10-years would help meet some of the Government's housing market objectives but to lesser extent than a longer period. The extension may put some downward pressure on house price inflation in the short to medium term, and provide equity and efficiency benefits as more economic income is taxed, however these benefits will be significantly less than for a 20 year period. Conversely, extending the bright-line test to 10 years may put some upward pressure on rents, but less than for a longer extension, and have potential lock-in effects (although the additional costs of these are unclear, and the Treasury's view is that lock-in will not significantly reduce housing utilisation). It may be relatively easy to avoid the tax liability under a 10 year test by delaying the sale of property.

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22 See Net Worth of residential (rental) real estate, *Household expenditure statistics 2018*, Statistics NZ.

Option 3B and 3C: Extending the bright-line period to 10 years for property acquired on or after the application date with exemptions for new builds

Providing either a full or partial exemption for new builds from a ten year bright-line extension would have similar impacts to Options 1B and 1C, though to a smaller extent.

Section 5: Conclusions

5.1 What option, or combination of options is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

In light of the Government's objectives and the above constraints, on balance the Treasury's preferred option is **an extension of the bright-line period from 5 years to 20 years with no exemption for new builds**.

While tax settings are not the primary driver of problems in the housing market, extending the bright-line test should put downward pressure on house prices in the short to medium term, and provide equity and efficiency benefits in taxing more economic income. However, extending the bright-line test may put upward pressure on rents.

While the extension may result in lock-in effects, the additional costs of these are unclear. The Treasury's view is that lock-in will not significantly reduce housing utilisation.

Therefore, the Treasury considers the measure improves the tax system on balance and contributes to the Government's stated demand-side housing objectives: to support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers.

The Treasury's preferred option is a 20-year bright-line test, however it also considers a 15-year bright-line test is superior to the status quo as it would help meet some of the Government's housing market objectives - but not to the same extent as a 20-year bright-line test. In the time available, the Treasury has not formed a view on whether a 10-year bright-line test is preferable to the status quo.

The Treasury does not recommend providing an exemption from the extended or existing bright-line test for early investors in newly constructed homes. An exemption comes with additional administrative and compliance costs, and over time reduces the coherence of the tax system. While increasing housing supply is important, the Treasury considers there are likely to be better ways to directly support supply, for example through an explicit subsidy for developers. If the Government wishes to implement an exemption, the Treasury prefers exempt property to be subject to the 5 year bright-line test.

There are significant data and analytical limitations, and so there is a low rating for the evidential certainty of the relevant impacts. In addition, the analysis has been prepared under significant time constraints, further limiting the evidential certainty.

Due to time constraints, there has been no opportunity for consultation on the proposal to extend the bright-line period or the proposed exemption for new builds.

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 where appropriate, 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			
Regulated parties: Residential property investors	Extending the bright-line test would increase the expected tax paid by property investors. This could put downward pressure on house prices. For the marginal investor, the proposals could be the 'tipping point,' so they would forgo the purchase, as other alternative investments become relatively more attractive. However, 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 extended bright-line, including those who did not acquire the residential property with an intention of resale. This could discourage investors concerned that they may face unexpected circumstances that would lead them to have to sell before 20 years has passed. The extended bright-line test also increases the incentive for investors to hold on to their properties for a period exceeding 20 years (the "lock-in effect"). They 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	The quantum of the impact on residential property 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 investors is not able to be quantified. House prices continued to rise at the same time as the bright-line was introduced in 2015 and extended in 2018, however it is not possible to determine whether they would have increased more in the absence of those policy changes or the extent of the impact that the bright-line may have had. It is difficult to predict the impact of a much lengthier extension. One indicator of the possible impact on property investors is the estimated increase in tax revenue. Inland Revenue's static	Low

	distortion may reduce their overall gain.	model predicts that there will be no new revenue over the forecast period, as any sales in this period would be captured by the existing 5 year bright-line test. The static model suggests that an extended 20 year bright-line will start generating revenue in 2029. On the assumption of no behavioural changes, the sums generated should increase over time and could reach around 0.2% of GDP in annual revenue 2035, depending on the behavioural responses of investors.	
Regulated parties: Owner-occupiers	To the extent that the extension of the bright-line test succeeds in reducing demand from residential property investors, this could result in house prices being lower than they would have been otherwise. This could negatively impact current owner-occupiers, and reduce their financial capital.	Due to the lack of empirical data, this impact cannot be quantified, but it is expected to be marginal (for the reasons set out above).	Low
Regulated parties: residential tenants	The extension may put upward pressure on rents through decreasing rental supply. This means renters may be negatively impacted by the proposals. Increased rents may impact tenants' living standards as it may mean that housing costs are high compared to their incomes or they are forced to live in premises that are not suitable for the occupants or the number of occupants, and limit their level of privacy and personal space. It may also cause crowding. Overall, this would reduce their financial and social capitals. To the extent that proposals place upward pressure on rents, this appears more likely to	Due to the lack of empirical data, this impact cannot be quantified. It would depend on both the market conditions and the behaviour of market participants. 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	Low

	disproportionately impact low-income households, younger people, Māori, and Pacific peoples, who are less likely to own their home relative to the general population. In addition, as around 43% of children are living in rental accommodation, upward pressure on rents could have negative impacts on child wellbeing and child poverty. Some renters may take advantage of lower house prices to become owner-occupiers. This would give them the opportunity to increase their financial and social capitals.	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.	
Regulated parties: stakeholders with interests in macro-financial stability (including banks)	To the extent that the extension of the bright-line test succeeds in reducing demand from residential property investors, this reduction in aggregate demand for residential property at the margin may reduce price pressures, all else being equal. If there was a large price impact, this may have a negative impact at the margins for banks.	The impact for banks is unquantifiable but is unlikely to be significant. The Reserve Bank has advised current banking system buffers are strong.	Low
Regulators/ regulatory agencies	To implement the extension to the bright-line period (and relevant changes), there will be administration costs to Inland Revenue and LINZ to the extent updates are required to the relevant forms, systems and guidance.		
Wider government	To the extent that the policy results in increased pressure on rents, it may also lead to an increase in spending on the accommodation supplement and temporary additional support.	Due to the lack of data, it is difficult to quantify this impact at this stage.	Low
Total Monetised Benefit	We do not have confidence in the ability to provide a total monetised cost	Low	Low
Non-monetised costs	As described above	Low	Low

Expected benefits of proposed approach compared to taking no action			
Regulated parties: first home buyers	At the margin, reduced competition from residential property investors in the market may reduce pressure on prices and make it somewhat easier for prospective first-home buyers to purchase a property. This would improve their financial capital and social capital (as indicated above).	Due to the lack of empirical data, this impact cannot be quantified. It would depend on both the market conditions and the behaviour of market participants.	Low
Wider government	Increased revenue would be collected from the sale of residential investment property, as the extension of the bright-line test would make more sales taxable.	Inland Revenue's static model predicts that there will be no new revenue over the forecast period, as any sales in this period would be captured by the existing 5 year bright-line test. The static model suggests that an extended 20 year bright-line will start generating revenue in 2029. On the assumption of no behavioural changes, the sums generated should increase over time and could reach around 0.2% of GDP in annual revenue 2035, depending on the behavioural responses of investors. This on the basis of no exemptions for new builds.	Medium
Total Monetised Benefit	We do not have confidence in the ability to provide a total monetised benefit.	Low	Low
Non-monetised benefits	As described above.	Low	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. 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 investors (as noted above), there are wider impacts 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. The reduced flow could arise from the reduced utilisation of the housing stock, as the extended bright-line test may discourage people selling property to others who may put it to more productive use, such as housing intensification or a higher utilisation rate.
2. If the proposals reduce demand from investors, this may (all else being equal) improve affordability for first-home buyers (as they face less competition in the market from investors) (this is the objective of the measure). This has other non-monetary flow on impacts, such as greater stability of tenure (and the associated secondary benefits), or 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.
    - Lower savings: if alternative investments have lower yields, this will reduce savings (particularly retirement savings) of people who would have otherwise been landlords.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

The Treasury and Inland Revenue understand that Ministers intend the proposals to apply to new purchases of property only. Given this, there is a risk that if there is a delay between announcement and the time from which the proposals apply, investors will seek to purchase property before the proposals apply.

Officials recommend aligning the date of announcement with the date at which new purchases will be subject to the new regime. This means that when legislation is enacted, it will apply retrospectively.

There is likely to be an expectation that when the changes are announced, there will be a sufficient level of detail to allow people to assess whether the changes apply to them, given that the Government will be announcing its intention to pass retrospective legislation.

Bright-line announcement

Officials recommend announcing that the bright-line extension is intended to be applicable from 11.59pm on the day of the announcement.

6.2 What are the implementation risks?

There has been no consultation on these proposals to date. A consultation process on how the proposals would be implemented would mitigate any risk of overreach (including properties not intended to be affected) or under-reach (not including intended properties).

Section 7: Monitoring, evaluation and review

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

To assist work on compliance with property transactions, Inland Revenue now includes property-related information into its Data Intelligence Platform (DIP). The DIP brings together data from different sources to provide an end-to-end view of property transactions throughout New Zealand. While still under development, the DIP is being used to identify suspected cases of property non-compliance and is a searchable record of customers' past property transitions.

To support an extended bright-line period and exempting new-builds from the new rules, Inland Revenue would look to enhance information it collects from customers directly and/or via LINZ, however the details of this are still being worked through.

Given the many competing influences on housing affordability, officials do not expect to be able to monitor the impact of this arrangement on the housing market, house prices, or rents.

7.2 When and how will the new arrangements be reviewed?

There are measures in place to review the existing 5-year bright-line test. These measures will continue to be used for an extended bright-line test.

Policy officials maintain strong communication channels with stakeholders in the tax advisory community, and these stakeholders will be able to correspond with officials about the operation of the new rules at any time. If problems emerge, they will be dealt with either operationally, or by way of legislative amendment if agreed by Parliament.