Tax Working Group Information Release

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The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the Group or the Government.

Coversheet: **Residential property compliance work**

Background Paper for Session 12 of the Tax Working Group
June 2018

Purpose of discussion

This paper seeks to respond to the Group's request for more information on Inland Revenue's property compliance programme. It covers:

- The property compliance programme
- The bright-line test
- Withholding taxes.

Key points for discussion

- Is there any further information or advice that the Group would like on property compliance.
- Does the Group wish to make any comments on property compliance as part of its interim report.

Recommended actions

We recommend that you:

a **indicate** whether the Group wants any further information on property compliance.
b **indicate** whether the Group's interim report should include material on property compliance.

Residential property compliance work

Background Paper for session 12
of the Tax Working Group

June 2018
Prepared by the Inland Revenue Department and the Treasury

1. Residential property compliance work

1.1 Content and scope

1. The Tax Working Group asked the Secretariat to provide further information on property compliance.

2. The Property Compliance Programme commenced in 2008 following investment of $14.6 million over three years, announced as part of Budget 2007. This funding was to target several key areas of property risk, including speculation and the use of loss attributing qualifying companies (LAQCs).

3. Further investment of $26.6 million over four years occurred in Budget 2010 to build on the success of the earlier property compliance initiatives. The Budget 2010 funding was base lined in Budget 2013 to allow work to continue in this area, with the appropriation changes taking effect from 2014/15.

4. In Budget 2015 Inland Revenue received an additional $29 million over a five year period, predominantly to focus on emerging risks in speculative activities, particularly in the Auckland property market. This investment was to provide:
   a. expansion of analytical capability;
   b. more resources for work in establishing intention of resale; and
   c. further customer education.

5. Inland Revenue now receives near real time information on all land sales from Land Information New Zealand (LINZ). This information enables us to monitor and make initial judgments about customer compliance with the property tax rules, particularly with the bright-line test, once tax returns are filed.

1.2 Property compliance programme

6. The Property Compliance Programme has conducted a range of activities since being introduced, the major focus of which has been ensuring those involved in property dealing or speculation pay their fair share of tax. Compliance activities primarily have been focused on audit as the funding received for property compliance has an expectation of a dollar return.

7. In addition to audit activities, the Property Compliance Programme has conducted outbound campaigns such as the LAQC campaign where we contacted about 50,000 customers. The Property Compliance Programme has developed and published web tools and guides to assist people to comply with all aspects of property taxation. These resources are among the most highly visited web pages on the Inland Revenue website. The Property Compliance Programme has conducted extensive intelligence gathering which is utilised in identifying and delivering not only

potential audit cases but also specific customers for targeted marketing campaigns to increase awareness of property taxation matters.

8. In addition, the Property Compliance Programme has developed processes which enable property transactions to be monitored. Currently Inland Revenue tracks over 60,000 property transactions which have historically been the subject of GST claims and each sale is checked for compliance.

9. Currently, Inland Revenue's main focus remains in relation on speculators. We have focused on speculation in and around new developments, infill housing, regional hot spots, and properties which have been sold within a short duration.

10. As a result of our property related activities, Inland Revenue has assessed additional tax in excess of $630 million since 2008 (please refer to Appendix 1 for a breakdown).

1.3 Bright-line test

11. The bright-line test came into force for residential property acquired after 1 October 2015. It originally applied to residential property sold within two years of being purchased, subject to some exemptions. Residential property acquired on or after 29 March 2018 is subject to a five year bright-line period. These rules do not apply to the sale of a person's main home.

12. The bright-line test applies to residential property sales where those sales are not taxable under another provision. Bright-line sales currently represent less than 10% of all taxable residential property transactions.

Table 1: Bright-line Property Transactions by tax year

	2016	2017	2018
Residential property transactions	97,625	204,323	177,955
Purchased and sold within the bright-line period	4,735	21,226	25,622
Meet bright-line criteria and not subject to an exemption or taxable under another provision	272	3,691	6,281

13. In September 2017 Inland Revenue reviewed compliance with the bright-line test for residential property sales that occurred in the 2016 tax year. Of the 272 bright-line transactions, we estimated that the level of non-compliance with the bright-line test was about 66% (or 180 out of the 272 transactions). Where audit work has been completed, it has confirmed non-compliance in about 50% of cases. The other 50% of suspected non-compliance cases, audited to date, were found to be compliant.

14. Inland Revenue has begun estimating voluntary compliance levels with the bright-line test for the 2017 tax year.1 We have used information from tax statements provided by LINZ to identify potential compliance issues with bright-line transactions in the 2017 tax year.

15. Initial results indicate a slight decrease in voluntary compliance levels in the 2017 tax year. In the 2017 tax year 3,691 property transactions met the criteria for bright-line. In each case, the sale was within two years of the property being purchased and no exemption was claimed on the tax statement provided with the sale. Analysis of these sales has identified that potentially 2,625 transactions (71%) have not yet complied with the requirement to return the sale for income tax purposes.

16. This estimation is based upon the sellers involved in the sale of the title having either not completed a tax return, or completed a tax return and not included any "Other Income" or "Business Income".

17. This is not entirely unexpected as the holding period for property increases. Bright-line properties sold during the 2016 tax year were held only for 6 months; properties sold in the 2017 tax year were held for up to 18 months. It is possible that the longer the period that a property is held for; the less likely sellers are to consider the proceeds taxable.

18. Returns for the 2018 tax year are not yet due. Inland Revenue estimates 6,281 title sales in that period for which a return is expected to include bright-line sales income.

Improving bright-line compliance

19. Inland Revenue is adopting a number of approaches to improve compliance with the bright-line test. This includes:

    a. Continuing audit activity on the remainder of the non-compliant customers identified as undertaking property transactions during the 2016 tax year (refer Table 1). At this stage no further cases have been closed since the March update (IR2018/152) as audit activity is on-going.

    b. Our Community Compliance officers have commenced calling and visiting customers with bright-line obligations outstanding for the 2017 tax year to discuss the requirement for the customer to file their return. 500 customers were selected for contact, and as at 16 May 2018, 427 customers have been contacted.

    c. Proactively contacting the customers associated with the 6,281 transactions we have identified as having a bright-line obligation for the 2018 tax year to

[1] All returns for the 2017 tax year were due by 31 March 2018.

advise them of their obligations and the information they will need to include with their return:

- We will initially target salary and wage earners (2,401 transactions) in the first instance as they have not previously had to file annual tax returns;
- Priority will be given to making contact with customers who do not have a current tax agent/accountant (1,456 transactions); and
- Our goal is to contact these customers prior to return filing dates and work with them to ensure they comply voluntarily.

d. Inland Revenue will continue to audit those customers who still fail to comply.

1.3 Withholding taxes

20. The residential land withholding tax (RLWT) applies to residential property sales, where the vendor is an offshore person, and the sale occurs within the bright-line period. The vendor's solicitor withholds at the lower of 10% on the sales price, or 33% on the gain. Vendors can choose to file and square up the amount of tax at a later point.

21. To date Inland Revenue has received over $13 million of RLWT. Table 2 provide a breakdown of the amount of RLWT deducted.

Table 2: amount of RLWT deducted and passed to Inland Revenue

Year	Offshore Sellers	RLWT deducted
2017	119	$6,184,809
2018	198	$7,317,725

22. IR captures the amount of RLWT it receives. It does not currently capture the adjusted amount where vendors have filed. The result is that we do not have any way to assess the accuracy of the RLWT.

23. An element of imprecision with amount of tax withheld might be appropriate for tax collected from overseas-based persons. The justification for the RLWT was that Inland Revenue found it difficult to collect tax from overseas based persons in any event. The problem of collectability is not as strong for onshore persons.

24. The level of voluntary compliance with the bright-line test by residents does raise the question of whether there might be a better way to collect bright-line income. However, for withholding taxes to be sustainable there needs to be comfort that withholding is being applied correctly and that the amount of tax withheld is broadly correct.

25. A small number of audit enquiries (36) suggest that data errors explain about 10% of those transactions that were initially assessed as bright-line transfers, but turned out not to be.

26. Further, setting withholding tax rates that are broadly accurate for those selling bright-line property will be a challenge. A withholding regime that collects and then refunds significant amounts of money to vendors does not seem appropriate, particularly in the context of people selling property and trying to purchase a new property. Over-withholding in these circumstances could cause serious problems, including failed settlement of other purchases. Setting accurate withholding tax rate(s) is easier where there are no deductible costs. However, bright-line property sellers will have costs that they should be able to deduct. This would need to be worked through.

27. In saying this, the Secretariat recognises that the suitability of withholding taxes will need to be considered as part of the design of any capital gains tax.

Appendix 1

Property investment, additional revenue assessed and return on investment since 2007/08.

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18[2]	Total
Investment												
Budget 2007 ($m)	2.93	5.84	5.84									
Budget 2010 ($m)				6.64	6.64	6.64	6.64					
Budget 2010 (base lined in Budget 2013)[3] ($m)								6.65	6.65	6.65	6.65	
Budget 2015 ($m)									3.00	6.50	6.50	
Revenue												
Target discrepancies ($m)	7.35	29.41	29.41	45.00	45.00	45.00	45.00	45.00	66.27	90.38	90.38	538.20
Additional revenue assessed ($m)	15.01	36.28	31.83	48.80	40.03	53.81	52.44	67.09	69.00	116.86	104.48	635.63
Return on each $1 of investment (ROI)[4]	$5.13	$6.21	$5.45	$7.44	$5.72	$8.42	$7.88	$9.97	$6.70[5]	$8.28[6]	$8.87	

[2] Year to date, 30 April 2018.

[3] On 15 April 2013, as part of the Budget 13 Package: Vote Revenue, Cabinet approved a continuation of the Budget 2010 property compliance initiative, with the appropriation changes taking effect from 2014/15 and continuing to 2016/17 and future years. As a result of this continuation of funding there was a corresponding increase in the targeted revenue assessed of $45 million per annum.

[4] The ROI for 2007/08, 2008/09 and 2009/10 are an indicative internal result only. Inland Revenue was not subject to formal measurement of ROI until 2010/11.

[5] In 2015/16 Inland Revenue began reporting an impaired ROI to reflect that a portion of the additional assessed revenue will become overdue debt.

[6] The ROI is specific to Budget 2015 activities only.