Tax Working Group
Te Awheawhe Tāke

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Coversheet: Fair rate of return method for rental property

Position Paper for Session 22 of the Tax Working Group
8-9 November 2018

Purpose of discussion

This paper summarises the Group's discussion at its 12 October meeting, provides a fair rate of return option that reflects the Group's requests at that meeting, and provides advice on the pros and cons of that option.

Key points for discussion

- Whether to recommend a fair rate of return option in the final report.

Recommended actions

We recommend that you **agree** to not recommend the fair rate of return method in the final report, in light of the problems identified.

Fair rate of return method for rental property

Position Paper for Session 22
of the Tax Working Group

November 2018

Prepared by the Inland Revenue Department and the Treasury

1. Introduction

1.1 Purpose

1. This note summarises the discussion on 12 October 2018 and collects together the various changes that were suggested to adjust the “Risk Free Rate of Return” (RFRM) set out in the paper for that meeting. The paper provides a brief assessment of these changes, and summarises the overall advantages and disadvantages of a fair rate of return method.

1.2 Meeting summary

2. It was suggested that we alter the name of the proposal because of the doubt that 3.5% was a truly “risk-free rate”. “Fair rate of return method” was suggested.

3. Members expressed concern that short-term speculative gains would appear to not be taxed under the fair rate of return method, so thought there should be tax on any speculative gains. The Secretariat’s view is that if it is thought that a tax is needed on these gains, the existing five year brightline rule (rental property bought and sold within five years is taxable on any gains) is probably the best approach that we have, as it was found that previous “intention” tests were hard to audit and hard to prove.

4. The Group were of the view that the system should not apply to holiday homes, as the cash flow is not available to pay the deemed return. Fiscal estimates are updated for this, and for including five year brightline revenue. These two changes roughly offset one another. The fiscals are in Chapter 4.

5. The Group also raised two particular issues:
   - Whether a fair rate of return method would have a greater or lesser impact on tenants in terms of any “pass through” of the tax.
   - Whether incentives to maintain the property would be less if a tax deduction was unavailable for the costs of maintenance.

2. Analysis

6. We reiterate the first fundamental issue, raised in the paper for session 20, that the appropriate rate of the fair rate of return is unclear. We have provided costings on two bases: 1.7% and 3.5%, but in the rest of this note we assume the rate is 3.5%. It is hard to be confident of whether income is being overtaxed or undertaxed when there is this degree of uncertainty about the most appropriate rate.

2.1 Fair rate of return and taxing "speculative gains"

7. The first point to make is the point made in chapter 2 of the session 20 paper *Risk-free return method of taxation*; that if there are no economic rents or embedded labour income, the risk-free return method of taxation will be broadly equivalent to a comprehensive income tax.

8. The concern that there can be labour income (from a landlord renovating a property and selling it) from returns to residential property suggests that this method of taxation is ill-suited to residential property. Attempting to fix that with a brightline or speculation rule will only resolve that problem if it is sold within five years (if the solution is the brightline rule). To fix the issue more completely, taxing gains on a realisation basis (and rents as they are now) may be preferable.

9. If the Group wanted to tax on a deemed return basis, but have additional tax if there was an element of intent or speculation regarding the sale, a solution might be that if a property was bought and sold within five years, the owner would pay tax on a deemed rate of 3.5% on the opening market value of equity each year, and then pay tax on the amount of any gain when sold. If the property was held for more than five years, the only tax paid would be on the 3.5% deemed return on the opening market value of equity.

10. As a result, the difference between the fair rate of return method described above and the system we currently have is that instead of paying tax on rent and deducting actual costs, rent and actual costs are ignored, and tax is paid on deemed return. The five-year brightline rule would apply to both.

11. This raises the issue that there will be incentives to sell rental properties that have decreased in value before the five-year brightline is passed, while retaining properties that have risen in value beyond this date.

2.2 Boundaries between rental properties and holiday homes

12. By excluding holiday homes, the tax system may create a difference between the treatment of holiday homes and rental property that could be a significant problem. In short, from a tax perspective, it may be preferable to have a property classed as a "holiday home" rather than a rental property.

13. Suppose initially that there were no tax on realised capital gains on holiday homes. If a house is rented to tenants year-round, the fair rate of return method would apply. If instead it was a holiday home that was rented out for several months per year, there would need to be a decision on how that was taxed. If it were taxed merely on the rental income, the

tax on the property would be less. This may, at the margin, encourage owners to favour short-term tourist rentals for properties that could be classified as holiday homes, over stable tenancies.

14. An alternative might be that holiday homes that are never rented out have a realisation-based capital gains tax applied when sold, but for part-time rentals the fair rate of return method might apply but be apportioned by the amount of the year that it is rented out (i.e. if it is rented out for 30% of the year, the fair rate of return is applied with a 70% discount). However, this might create an incentive to rent it out for a few days per year to avoid paying tax on capital gains on sale. If that means that holiday homes are taxed on an apportioned fair rate of return method with a CGT on sale, then it will be greater taxation of holiday homes than rental properties sold after five years.

15. A solution might be to apportion the capital gain for the portion of the holding period that it was **not** rented out. However, this starts to become very complicated.

16. As an example, assume a holiday home is purchased for $500 000, 100% equity financed, rented out for 1 month per year, and is sold after six years for $650 000. The tax rate is 33%.

17. Each year the deemed income under the fair rate of return would be $500 000 * 1/12 * 3.5% * 33%, which is $481. After 6 years 11/12 of the capital gain (representing the period where it was **not** rented out**)** would be taxed, resulting in tax of 11/12 * $150 000 * 33%, which is $45 375.

18. In short, boundaries are complicated to address, and it is likely that rules as described above would be met with confusion.

2.3 "Pass through"

19. Given the theoretical economic equivalence between the risk-free return method of taxation and comprehensive income taxation, if the deemed rate was set at the risk-free rate we would not expect any difference in pass through due to the form of the tax. The fair rate of return does raise more revenue more quickly, but overtime is eclipsed by a realised capital gains tax. If landlords are forward looking the timing of the tax revenue should not affect their decisions other than through the interest rate at which they discount future obligations.

20. As has been pointed out previously, the question of the true risk-free rate is one that the Secretariat has reservations about. This flows on to the amount of revenue raised by the tax. If there is more revenue (on a risk-adjusted basis) under the fair rate of return method, and the concern is that some incidence will fall on renters, the "fair rate" could be scaled back to reduce this impact. Of course, this will cost revenue, and also tax the other parties who bear the incidence (i.e. landlords) less.

2.4 Incentives to maintain the property

21. If one assumes that landlords do maintenance on their property when it is profitable to do so, then we would expect no change on incentives with a switch to a fair rate of return method. This is because while the costs of maintenance will no longer be deductible, the return through increased rent will no longer be taxable.

22. To take a specific example: a landlord is thinking about whether she should spend $375 to fix a door that lets through a cold draught. The landlord thinks she will be able to earn an extra $400 in rent from the current tenants at the next rent review coming up if she fixes the door.

23. Under an income tax this is a profitable maintenance expenditure, as while the rent is taxable, the expenditure is deductible. At a 33% tax rate the $400 rent reduces to $268 after tax. The expenditure is deductible, and so also reduces so that the after-tax cost is $251. After tax there is still a profit available.

24. Under the fair rate of return method there is no deduction available, but the increase in rent is not taxable and, as a result, it is still profitable. The underlying point is that provided that deductions are allowed for costs, anything that is profitable under the fair rate of return method will be profitable with an income tax.

25. There may be a concern that if income tax rates are very high, or pre-tax profits are very low, landlords may worry about whether it is worth even bothering to do the maintenance given that the after-tax return is even lower[1]. We do not expect this to be a major reason for qualifying the analysis at current New Zealand tax rates. The fundamental point is that if deductions are allowed for costs, the maintenance will still be profitable.

26. The above assumes that landlords are making their decisions to maintain properties based on a profit motive. If maintenance is a legal requirement, then the incentive to do the maintenance will not be different between the two systems.

2.5 Comment from Ministry of Housing and Urban Development

27. The Ministry of Housing and Urban Development were given the opportunity to comment on this paper and made the following points:
    - The Ministry agrees with the Secretariat recommendation to not pursue the fair rate of return method.
    - The Ministry's primary and most significant concern is the impact of the fair rate of return method on the capacity for landlords to meet the cost of bringing properties up to quality standards. In their view, the fair rate of return method would reduce rental supply, delay improvements in quality and increase rents. This is because the fair rate of return method will add significant new cost increasing the likelihood of exit and worsening supply conditions further. In this way the fair rate of return method would

[1] This would tend to support the view that the fair rate of return method would result in more rather than less maintenance.

undermine the objectives of the broad set of reforms aimed at lifting the quality of rental housing.

- The Ministry also queried the single rate across all of New Zealand, suggesting that if it was set too high for urban centres then the cash flow impact would exacerbate the transitional impact above but also distort on a steady state basis.
- On the question of incentives to do maintenance, the Ministry argue that if one assumes the costs to bring up to standard have been met, then on an ongoing basis the key change is that the landlord meets the full marginal cost of maintenance without a tax deduction and that this might provide an incentive to defer maintenance. Against this are new added penalties and a shift towards prescriptive standards that might mitigate this. Landlords would have stronger incentives to keep good tenants as the fair rate of return method would apply irrespective of occupancy.

Independent advisor comment

The Independent Advisor notes the significant immediate revenue that could arise from a fair rate of return method. This shows the current scale of under taxation of the sector, particularly as recent estimates of FDR on shares at a higher rate was revenue negative. The additional question though is how much this extra immediate tax impost could, in practice, feed into rent increases or deferred maintenance compared to a more delayed taxation of realised capital gains.

3. Pros and cons of fair rate of return method and realised CGT

28. The primary benefit of a fair rate of return method is that there is no lock-in after five years (assuming the brightline rule applies to sales within five years – if not, there will be no lock-in whatsoever). However, there will be significant lock-in before five years (if the property has appreciated) with owners incentivised to wait for the full five years before selling.

29. A significant and undesirable aspect of the fair rate of return method is that it is likely to lack public understanding. People may fail to see the connection with taxing a deemed rate of return and taxing more capital gains. If a landlord makes a large gain but pays tax on 3.5% of the equity value per year and no tax on the gain (because it is sold after five years), it will appear to many that the landlord has been undertaxed.

30. While the fair rate of return may seem less of a transaction-based "nest egg" tax than the tax on capital gains on realisation, all other retirement savings are either already taxed or would be taxed on a realised basis under the proposals. This is an unavoidable feature of a realisation-based tax and the person does benefit from deferral over their period of ownership.

31. It is likely that the fair rate of return method requires apportionment rules for holiday homes to avoid situations where people find themselves incentivised to either leave the property empty if they would prefer taxing capital gains treatment to fair rate of return treatment.

32. For completeness, we note that the session 20 paper on the risk-free return method concluded that the risk-free return method is unlikely to be appropriate in cases where:

- labour income can be bundled into the return,
- there are economic rents that are not capitalised into asset prices,
- there is insufficient cash flow from the asset to pay the tax, and
- an asset is difficult to value.

33. The paper pointed out with examples that this will be true to some degree of residential rental property.

34. When compared with a tax on realised capital gains on residential property, the Secretariat's view is that the fair rate of return is inferior. The benefits of the tax on realised gains are that it is generally understood as a concept by the public, and does not require apportioning systems to create a hybrid of fair rate of return with taxing capital gains.

35. The primary downside of a taxing capital gains on rental property is lock-in. However, it should be noted that to date, the Group has not generally expressed a view that lock-in for residential property is a particular problem, and has not featured in the Group's debates about rollover relief. That is, the rollover options being considered do not include residential rental property. That might suggest that the main downside to taxing capital

gains on a realised basis (lock-in) is not an impediment to making this a viable option for residential property.

4. Conclusion and recommendation

36. Putting all the above together, the fair rate of return method seems to have significant downsides:

    - It is complicated - it mixes some elements of deemed return with some elements of actual return (if sold within five years). It is less likely than a tax on realised capital gains to be well understood.
    - It requires apportionment rules to deal with holiday homes.
    - It will result in undertaxation relative to an income tax when labour income can be bundled into the return.
    - It will result in undertaxation relative to an income tax when there are economic rents that are not capitalised into asset prices,
    - There may be situations where there is insufficient cash flow from the asset to pay the tax, and
    - It requires accurate valuations.

37. The Secretariat recommends that the Group decline to take the fair rate of return method further, and to concentrate on the realisation-based capital gains tax. If the Group decides that a comprehensive tax on realised capital gains is not worth recommending, it would still have the option of recommending a tax on realised capital gains for residential rental property and holiday homes.

4. Updated fiscal estimates

Table 1: Excluding holiday homes and including brightline revenue, relative to status quo

Fiscal year ($m)	**2021/22**	**2022/23**	**2023/24**	**2024/25**	**2025/26**	**2026/27**	**2027/28**	**2028/29**	**2029/30**	**2030/31**
3.5% risk-free rate	912	949	1,075	1,171	1,266	1,361	1,465	1,579	1,702	1,835
1.7% risk-free rate	112	99	185	221	256	301	345	389	442	495

Table 2: Excluding holiday homes and including brightline revenue, relative to taxing capital gains

Fiscal year ($m)	**2021/22**	**2022/23**	**2023/24**	**2024/25**	**2025/26**	**2026/27**	**2027/28**	**2028/29**	**2029/30**	**2030/31**
3.5% risk-free rate	707	454	317	169	20	-119	-249	-359	-471	-573
1.7% risk-free rate	-93	-396	-573	-780	-988	-1,177	-1,367	-1,547	-1,729	-1,911

Table 2 uses the forecast for taxing capital gains in the *Potential revenue-neutral packages* paper from session 21. All the caveats and assumptions are outlined in that paper.