Tax Working Group
Te Awheawhe Tāke

Tax Working Group Information Release

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

Some papers contain draft suggested text for the Final Report. This text does not constitute the considered views of the Group. Please see the Final Report for the agreed position of the Group.

Key to sections of the Official Information Act 1982 under which information has been withheld.

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[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people;
[2] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials;
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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

Retirement villages and capital income

Officials note from ETR report attached at end.

There are three primary ways retirement villages generate accounting income:

1) Unrealised revaluations of the value of the retirement villages. The underlying land and buildings are rarely if ever legally sold. The valuation change comes from a present value of the expected cashflow from the occupancy advances (or interest free loans).

2) The 'sale' of occupancy advances for use of the properties. Such advances, perhaps less a management fee, are returned to the resident, or the resident's estate, upon vacating the property. These can be treated as interest free loans from the resident to the company with the effect that there is value transferred to the company the longer the loan is outstanding.

   Such an approach has a tax benefit for the residents. Instead of earning taxable income from that advance and paying rent from the tax paid income; they get tax free imputed rents from the use of the property. That is instead of earning $100 which would give them $80 to pay rent; the entire $100 can provide an imputed rent.

3) Services to residents. This can come from periodic (often monthly) payments for services

Tax effects

1) The unrealised revaluation income is not included in taxable income under normal income tax rules. Even with an extension of the taxation of capital income to realised gains this would not be included in taxable income.

2) There is a specific determination for the interest free loans.[1] Embedded in the consideration component is both the receipt from the resident and the future payment to the resident. The latter because there is a legal obligation to repay the funds. Similar outcomes arise if they are not treated as interest free loans but occupancy advances. The occupancy advance is taxable but there is an equivalent deduction at the same time as there is a legal obligation to repay at any point determined by the resident.

3) The services income is returned as earned.

4) As the provision of residential property is one of the objectives of retirement villages, this is GST exempt meaning that no input tax credits can be claimed for

[1] http://www.ird.govt.nz/technical-tax/determinations/accrual/det-s16-retirement-village.html

these supplies although GST output tax is paid and input credits claimed on services such as care.

5) Dividends paid to shareholders are generally unimputed. This means that tax will be paid by the shareholders. Although to the extent charities or tax exempt own these shares there will be no further taxation. Non-residents should pay non-resident withholding tax of 15%.

Key cashflow effects

1) There are no cashflow effects from the unrealised revaluations.

2) Initially there is a cash outflow from the construction and a cash inflow from the interest free loan in the year it is received. Subsequently there is a cash outflow of the original advance and a cash inflow from the reoccupancy. According to the officials' note this surplus is the basis of the dividends paid to shareholders.

Overall effect

High accounting profit, low or no tax paid but dividends paid from the cash surpluses. No GST input tax credits available on the provision of residential accommodation and some tax paid at the shareholder level.

Options

1) Do nothing. In my view the time value of money benefit to the companies is the equivalent of rent. While rent is taxable; to earn a rental stream debt or equity is necessary to build the properties and buy the land. If debt is used, and as NZ companies there are no constraints, the interest would be deductible. Therefore it is arguable that the interest free loan – while providing no taxable income – also means there is no need for an associated deduction for interest. Further to the extent a dividend is paid there is tax paid at this stage. This argument weakens to the extent there are non-resident or exempts as shareholders.

   GST is a cost and a tax paid on the provision of residential property.

   Most importantly in the event income tax is extended to gains on the sales of shares; as the unrealised capital gains of the companies are reflected in the share price shareholders will be paying tax on the increase in the value of the properties.

2) Deem a realisation event when the occupancy changes hands. This could only be on the basis that the underlying substantive ownership has changed and this would be consistent with other realisation events.

3) Apply RFRM if rental properties generally were to become subject to RFRM. The logic could equally apply here. That is a component of the gain is the expected capital gain on sale.

4) Separate regime which delayed deduction til time was paid out. This would align with cashflows and how the business operates is terms of shareholders.

Group's preference

If income tax is extended to gains on the sales of shares, the group's preference is to do nothing particular for this industry as it will be fully taxed on its economic income albeit in a different way to other industries. A taxation of the gains on share sales will align New Zealand's tax settings of this industry with Australia's.

On this basis nothing particular to this industry needs to be discussed in the interim report. If, however, such a change to the taxation of capital income does not occur this may need to be reconsidered.

Andrea Black
8 August 2018

ii) Residential Care Services

Explanation provided in April 2018 report based on a sample of tax adjustment schedules

1. Most residential care service groups are in a tax loss position and do not have an ETR. Others operate as charities and claim a business income tax exemption under section CW 42. Irrespective of whether they are in a tax loss or tax profit position, if a residential care service group is not tax exempt then it typically makes the following significant tax adjustments.

<table>
<tr><td rowspan="4">Significant tax adjustments that <u>decrease</u> the effective company tax rate:</td><td>Unrealised gains and occupation rights adjustments
In addition to revaluations of properties owned by residential care services this includes adjustments made for sales of occupation rights.

Occupation rights are effectively interest free loans that a resident provides to a retirement village that roughly matches the value of the property a resident is moving into. When a resident leaves, the village repays the loan (minus a fee) and enters into a loan with a new resident based on an increased value of the property.

Some villages appear to treat the increase in the value of the loan as income for accounting; however the difference is not taxable.</td></tr>
<tr><td>Deferred management fees
Some firms have management fees that are payable when a resident of a retirement village leaves the village. There can be differences in when they are recognised as income for tax and accounting purposes.</td></tr>
<tr><td>Interest adjustments
This is mainly interest that is deducted for tax purposes but has been capitalised into the cost of the asset for accounting purposes</td></tr>
<tr><td>Tax depreciation being greater than accounting depreciation</td></tr>
</table>

Supplementary explanation

2. Residential care service groups do not have specific rules for calculating taxable income under the Income Tax Act. The form of the agreement between an operator and a resident will give rise to different tax consequences.

3. It is common for retirement villages to use "ingoing fees" (the entrance price), "exit fees" (a percentage of the ingoing fee when the resident leaves, eg 2% pa capped at 20%) and "exit entitlements" (a resident who leaves may receive an amount from the operator when the unit is sold to a new resident).

4. There are different views as to whether the economic gains should be taxed under current law. In general, retirement village operators claim that residents make an interest-free

loan to the retirement village operator (usually around 80% of the price for outright purchase) in return for a right to occupy a unit.[2] When the occupation right terminates and a replacement resident is found, the retirement village operator refunds the advance subject to certain deductions such as a 20% deferred management fee. The economic gain to the retirement village operator is equivalent to the difference between the original advance refunded to the exiting resident and the replacement advance paid by the new resident.

5. However this economic gain does not give rise to net income for tax purposes. This is because the replacement advance is fully repayable in the future (on the exit of the new resident). Accordingly any income arising on receipt of the replacement advance is immediately offset by an equal deduction for its future repayment[3]. This tax treatment is not altered by the fact that certain fees are offset against the future repayment.

6. A capital gains tax would not change this tax outcome. The tax outcome arises from the immediate offsetting of the replacement advance's future repayment (resulting in no net income), rather than the characterisation of that replacement advance as income or capital. We note that Australia has the same issue with taxing its retirement village operators, despite having a comprehensive capital gains tax.

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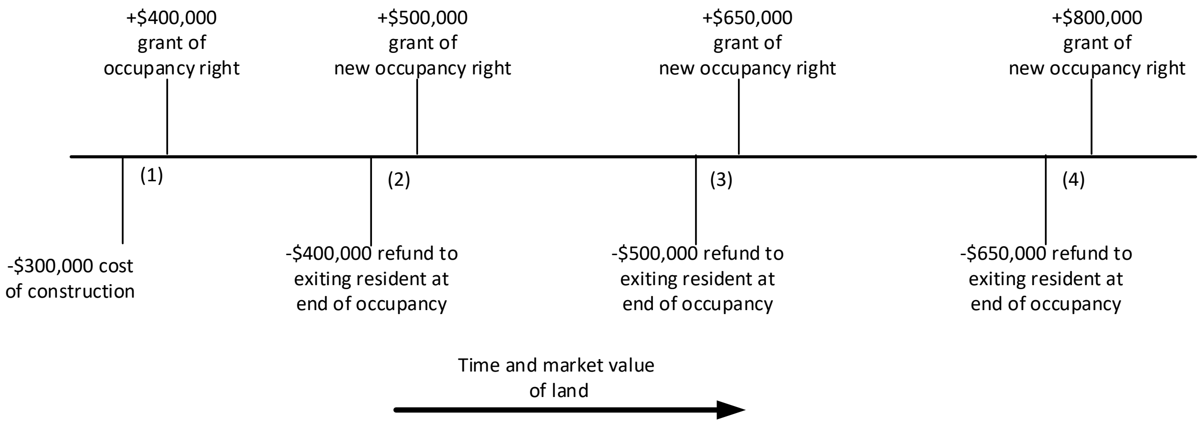
[2] Some retirement villages structure the payment as a refundable lease premium, but this does not change the tax result.

[3] This is under either the current financial arrangement rules (where the payments are structured as a loan) or the ordinary deductibility rules (where the payments are structured as refundable lease premiums)

7. The following example outlines the tax treatment of a typical residential care unit.

Residential care: tax treatment of a single unit



- Retirement village makes a cash gain on each new grant of an occupancy right for the unit, which occurs every 7 years on average. The gain equals the new grant price less the refund of the old grant price.
- The grant price is proportional to the current market value of the unit (80% of the freehold value). So the retirement village makes a cash gain on each new grant provided the land's market value has increased.
- Cash gain is $100,000 at (1), 100,000 at (2), 150,000 at (3), 150,000 at (4)
- The cash gain is returned as a realised profit for accounting purposes and used to pay dividends to shareholders.
- For tax purposes, the cash gain is ignored. Instead tax only sees a series of refundable lease premiums (or loans). Since each payment will definitely be refunded in full, it is never returned as income.
- Retirement villages also enjoy some tax deferral benefits in respect of depreciation and the deferred management fee. However, it is the above tax treatment that causes their persistently low effective tax rate.