Regulatory Impact Statement

Options for optimising the effectiveness of the bright-line test

Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

It provides an analysis of options for optimising the effectiveness and the integrity of the "bright-line test" proposed in the Taxation (Bright-line Test for Residential Land) Bill.

On 14 May 2015, the Government announced plans to introduce a bright-line test to buttress the "intention test" in the current land sale rules. The proposed bright-line test would require income tax to be paid on any gains from the disposal of residential land that is acquired and disposed of within two years, subject to some exceptions. The Government also announced plans to investigate the introduction of a withholding tax to collect revenue arising under the bright-line test.

The analysis in this RIS was informed by public feedback on proposals contained in the officials' issues paper *Residential land withholding tax*, which was released on 31 August 2015, and further discussions with practitioners involved in the conveyancing process. The issues paper proposed the introduction of a withholding tax to collect revenue on gains from the sale of residential property to improve compliance with the bright-line test.

The preferred option is to introduce a withholding tax, similar to that proposed in the officials' issues paper. It is designed primarily as a collection mechanism for the proposed bright-line test and so is not intended to raise Crown Revenue. As the preferred option would apply to a subset of bright-line sales, it would collect a portion of revenue arising under the bright-line test. The exact fiscal and compliance cost figures for the proposed bright-line test are not available because Inland Revenue does not currently have accurate data on the types and levels of land sales occurring or how much is collected under the current land sale rules.

The data for these areas is expected to improve as new information disclosure requirements for property come into force and Inland Revenue implements a new form to better monitor taxable land sales.

The analysis in this RIS needs to be considered in light of the additional constraint faced by Inland Revenue at the present time, which is its inability to make significant systems changes in advance of the relevant stage of development of its Business Transformation programme.

This proposal has been subject to public consultation and the design features take a number of these comments into account. However, owing to time constraints, the time provided for submissions was slightly shorter than the time ordinarily provided under the Generic Tax Policy Process. Further, the time between receiving submissions and reporting on the final design was compressed. As a result, we cannot be sure that the nature and scale of the

impacts and any potential unintended effects of the proposal have been fully considered in this analysis. We note that the Bill will be subject to a public consultation process as part of consideration by Select Committee.

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STATUS QUO AND PROBLEM DEFINITION

1. The Government is concerned with high house prices, particularly in the Auckland area. Other possible causes, both on the supply and demand sides, are being separately considered, but property speculation is seen as one of a number of causes of the current prices. The attractiveness of property speculation, when compared with other forms of investment increases, if the gains are able to be realised untaxed, when gains from other investments are taxed.

2. The main change arising from the Budget 2015 property measures is the proposed introduction of a "bright-line" test that will require income tax to be paid on any gains from the sale of residential property that is bought and sold within two years, with some exceptions.

3. The purpose of the bright-line test is to supplement the "intention test" in the current land sale rules. The intention test makes gains from the sale of real property purchased with an intention of disposal taxable. The intention test can be challenging to enforce due to the difficulty in proving a person's intention upon acquisition, which is a subjective test. The bright-line test is intended to deal with the problem by supplementing the intention test with an objective test.

4. If enacted, the bright-line test will generally apply to property acquired under an agreement for sale and purchase entered into on or after 1 October 2015. Legislation for the proposed bright-line test is included in the Taxation (Bright-line Test for Residential Land) Bill.

5. In addition to these measures, the Government announced that it would investigate the introduction of a withholding tax for non-residents sellers to collect revenue arising under the bright-line test. The Government directed Inland Revenue and Treasury officials to develop a withholding tax that could be implemented by mid-2016 to improve compliance with the bright-line test.

6. This regulatory impact statement deals with the question of how to optimise the effectiveness of the bright-line test and support the integrity of the new rules.

Compliance with tax obligations

7. New Zealand taxes its tax residents on their worldwide income. New Zealand also taxes foreign investors on income that is sourced in New Zealand. When a foreign investor has a branch or controls a subsidiary in New Zealand, tax can be imposed on the New Zealand-sourced income of that branch or subsidiary in the same way as it would be on New Zealanders. However, when the foreign investor does not have a New Zealand presence, it is more difficult for New Zealand to collect tax from them.

8. New Zealand's tax system operates on the principle of voluntary compliance, which relies on taxpayers understanding their tax obligations and how the wider tax system works.

9. Foreign investors may not always have the same level of understanding as taxpayers based in New Zealand, and they do not have the same level of connection to New Zealand that would otherwise create an intrinsic incentive to voluntarily comply with their New Zealand tax obligations.

10. While voluntary compliance is an important feature of New Zealand's tax system, withholding taxes are imposed on many types of income where there is likely to be a tax liability and there is the possibility of unenforceability or evasion. Withholding taxes are important in these situations because they ensure that the relevant tax is paid out of the amount due to the payee before the payee gets control of the funds. Under New Zealand's tax rules, the Commissioner of Inland Revenue (the Commissioner) has the ability to impose penalties on taxpayers who knowingly fail to deduct withholding tax from a payment they have made and on those who have withheld tax for any purpose other than for payment to the Commissioner.

11. Existing withholding taxes in the New Zealand tax system include withholding taxes on:

- employment income;
- interest and dividends;
- payments to certain contractors (including special rules for non-resident contractors, entertainers and insurers); and
- distributions from trusts.

12. In these situations, it is likely that the payee will have a New Zealand tax liability in relation to the income they receive, and in order to ensure the satisfaction of that liability, tax on that income is withheld before the payee receives the income.

13. The Commissioner also has a number of powers to enforce the tax obligations of taxpayers to assist in the collection of taxes.[1] One concern is that these measures are not always administratively practical or effective when the taxpayer has no presence in New Zealand.

14. New Zealand can request help to collect tax from foreign investors from overseas revenue authorities under its various international agreements, including the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, bilateral double tax agreements and tax information exchange agreements. These agreements allow for the exchange of tax-related information and assistance in the collection of taxes. While these are useful tools in enabling the Government to collect tax, they are a backstop and should not be the primary tool.

15. We are not able to quantify the size of the problem. This is because to date, Inland Revenue has not had access to detailed information about compliance with the existing land sale rules. However, information collection measures introduced in the Land Transfer Amendment Act 2015 will provide more useful information to Inland Revenue about land sales in the future. This information will enable Inland Revenue to have better information about compliance with the land sale rules and in particular, the proposed bright-line test.

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1 The Commissioner may impose a number of monetary penalties, including, for example, late filing, shortfall, and late payment penalties. The Tax Administration Act 1994 sets out when and at what rates such penalties may be charged. This ensures that penalties for breaches of tax obligations are imposed impartially and consistently, at a level that is proportionate to the seriousness of the breach.

In addition, the Commissioner has powers available to recover amounts of unpaid tax. These powers include requiring deductions from payments made to the defaulter by any other person, and court action.

OBJECTIVES

16. The objective is to both optimise the effectiveness and support the integrity of the proposed new bright-line test.

17. Optimising the effectiveness of the bright-line test involves maximising compliance with the new bright-line test, having regard to other factors such as compliance and administrative costs.

18. Supporting the integrity of the new bright-line test (which, if enacted, will form part of the tax system) is important in ensuring that New Zealand's tax system can effectively rely on the principle of voluntary compliance. The "integrity of the tax system" is defined in section 6 of the Tax Administration Act 1994 as including (among other factors) the responsibilities of taxpayers to comply with the law, and taxpayer perceptions of the integrity of the tax system.

19. In addition to the stated objective, the fiscal, economic, administrative, compliance, and fairness impacts of each feasible option will be assessed.

20. The fiscal impact is the likely effect of a given option on Crown Revenue. The bright-line test has been forecasted to raise approximately $5 million per year. As this analysis is targeted at optimising the effectiveness of the bright-line test, none of the feasible options identified and analysed in this statement are intended or expected to raise revenue, but may lend themselves to collecting a portion of the $5 million. The $5 million per annum figure forecasted for the bright-line test is based on a number of behavioural assumptions, which are inherently difficult to quantify, such as the number of sales that would be delayed in order to exceed the two-year holding period. The actual revenue collected under the two-year bright-line test may be significantly more if the behavioural responses are different to those assumed.

21. The economic impact of each feasible option will also be assessed, in particular, whether compliance with New Zealand's tax rules more generally may be affected and whether there may be possible flow-on effects in the residential housing market given that the proposed bright-line test is targeted at short-term churn and speculation in residential housing. The bright-line test has already been identified as creating a "lock-in" effect as people will have an incentive to hold onto property for longer than two years – this is an economic distortion as people may not undergo efficient transactions due to the bright-line test. The economic impact of each option identified in the regulatory impact analysis is over and above that of the proposed bright-line test.

22. An important component of any recommended approach is the administrative impact. Thus, the impact analysis of the feasible options includes whether, and to what extent, a particular option requires changes to systems in order to administer it, for example, whether changes are required to Inland Revenue's computer systems or other processes, and/or whether a particular option requires the use of additional resources to implement a solution or identify and investigate cases of non-compliance.

23. Conversely, the recommended approach should not unduly impose compliance costs, although some compliance costs are to be expected. The regulatory impact statement *Bright-line test for sales of residential property* noted that the bright-line test would increase compliance costs for those whose sales of residential property were not previously taxable under the intention test as they would be required to start accounting for income tax on their property sales. The compliance impacts identified in the impact analysis are over and above those identified for the proposed bright-line test.

24. As noted previously, New Zealand's tax system operates on the principle of voluntary compliance, which relies on taxpayers understanding their tax obligations and how the wider tax system works. Where there is unfairness or a perception of unfairness present in the tax system, people may be less willing to voluntarily comply with their tax obligations, which may undermine the integrity of the New Zealand tax system. Fairness (and the perception of fairness) is accordingly an important part of the principles underpinning the integrity of the tax system. As the New Zealand tax system relies heavily on people voluntarily complying with their tax obligations, we consider that the fairness impacts of any feasible option are significant in determining whether the option meets the stated objective.

REGULATORY IMPACT ANALYSIS

25. We note that the identification and analysis of a full range of practical options to achieve the Government's stated objective has been constrained by a number of factors:

- time available for policy design and consultation; and
- Inland Revenue's need to limit the amount of significant or complex changes within its legacy systems in advance of the relevant stage of development of its Business Transformation programme.

26. Further, the Government directed Treasury and Inland Revenue officials to develop a withholding tax to improve compliance with the bright-line test.

27. However, to assess whether the design of a withholding tax fully meets the stated objective, we have also evaluated the Commissioner's current tools for collection and other possible non-regulatory approaches to determine whether they may also be appropriate for optimising the effectiveness and integrity of the proposed bright-line test.

28. Four options for optimising the effectiveness and integrity of the bright-line test are considered below:

- Option 1: Rely on existing compliance measures (the status quo);
- Option 2: Status quo, but provide more guidance on tax obligations;
- Option 3: Status quo, but review effectiveness of bright-line test in three to four years; and
- Option 4: Introduce a withholding tax on sales of residential property made within the two-year bright-line period that:
    (a) is restricted to instances where the seller is an offshore person;
    (b) applies to all sellers.

29. Options 1–3 are non-regulatory responses, while option 4 is a regulatory response that would require both administrative and legislative changes.

30. Option 4 is divided into two possible approaches, with option 4(a) applying in instances where the seller of residential property is an "offshore person", and option 4(b) applying to all sellers regardless of their onshore/offshore status. We consider that these two differences in scope to be significant enough to warrant undertaking a full impact analysis for each approach. The overall effectiveness of both options 4(a) and 4(b) are dependent on a number of key design features. These features are discussed in further detail in the section titled *Further analysis of option 4 – detailed design issues.* Our recommendations regarding these design issues have informed our impact analysis on option 4.

Option 1: Rely on existing compliance measures (the status quo)

31. This option would require no legislative amendment and would instead rely on the Commissioner's existing tools for collection and enforcement, which we have outlined above and have also summarised below. It would also rely on the standard "business-as-usual" response to new legislation outlined in the regulatory impact statement *Bright-line test for sales of residential property* – this will include updating forms and communication material. To assist in the implementation of the bright-line test, Inland Revenue is also developing a new attachment to income tax returns.

32. As discussed in the regulatory impact statement *Bright-line test for sales of residential property*, one of the concerns with the "intention test" in the current land sale rules is that it is difficult for the Commissioner to enforce due to difficulties in establishing intent and the high volume and churn of residential property sales. The proposed bright-line test is designed to be an unambiguous and objective test. This in itself would improve compliance with, and the enforceability of, the land sale rules in the Income Tax Act 2007.

33. The status quo would be problematic from an enforcement perspective. The Commissioner has a number of tools available to assist in the collection of taxes, for example, late filing, late payment and shortfall penalties. In addition, the Commissioner has powers available to recover amounts of unpaid tax. These powers include requiring deductions from payments made to the defaulter by any other person, and court action. However, where the taxpayer has no presence or other assets in New Zealand, these tools and powers are not always administratively practical or effective.

34. Note that in situations where there is the possibility of unenforceability or evasion of a tax liability, withholding taxes are commonly imposed before the payee receives the income. Withholding taxes are important in these situations because they ensure that the relevant tax is paid out of the amount due to the payee before the payee gets control of the funds. This is discussed in further detail in the section titled *Status quo and problem definition.* However, in the case of residential property sales, the Commissioner's current tools for collection and enforcement do not include a withholding tax.

35. New Zealand can request help to collect tax from foreign investors from overseas revenue authorities under its various international agreements, including the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, and bilateral double tax agreements and tax information exchange agreements. These agreements allow for the exchange of tax-related information and assistance in the collection of taxes. While these are useful tools in enabling the Government to collect tax, they should only act as a backstop.

36. Inland Revenue does not have detailed data about the compliance of non-residents with their New Zealand tax obligations on their New Zealand-sourced income. However, there is anecdotal evidence that compliance with the land sale rules to date has been low, particularly in relation to non-residents. New information collection and reporting measures introduced from 1 October 2015 regarding residential land sales should provide better quality information in the future, but using this data to form views about compliance rates and trends regarding the proposed bright-line test will not be possible for several years.

37. Option 1 is not Inland Revenue's preferred option. It would make the tax system less coherent as a whole, given that withholding taxes are required in relation to other forms of income in similar circumstances (that is, where a payee is likely to have a tax liability and where there may be enforceability or evasion concerns). The absence of a withholding tax as part of the Commissioner's current tools for collection and enforcement is not practical where

the taxpayer has limited or no presence in New Zealand, which is where voluntary compliance with New Zealand's tax rules is less likely to occur. There is also a strong risk that this could create a perception that foreign investors are not paying their "fair share of tax" in relation to income derived from residential land, and that their tax obligations are not being sufficiently enforced, thereby undermining the integrity of the tax system.

Option 2: status quo, but provide more information guidance on tax obligations in relation to residential property

38. This option is a non-regulatory response that is similar to option 1, but in addition to the Commissioner's existing powers for collection and the standard "business-as-usual" response to new legislation, it would also involve additional information being provided and education campaigns being run in an effort to boost levels of voluntary compliance in relation to the new bright-line test (and potentially the other land sale rules).

39. Targeted education campaigns have been utilised by Inland Revenue in the past to deliver messages regarding significant changes to the tax system and to ensure those affected understand their obligations, for example in the child support area.

40. A similar strategy could be used for the proposed bright-line test, with the level of detail of the information provided and the medium dependent on the target audience.

41. However, a major limitation with this approach is that it requires in-depth knowledge of the appropriate medium in other jurisdictions to best ensure that the appropriate audiences are covered. As previously mentioned, Inland Revenue does not currently have access to detailed information about land sales in New Zealand. Information collection measures introduced in the Land Transfer Amendment Act 2015 and the Tax Administration Amendment Act 2015 will provide more useful information to Inland Revenue about land sales in the future. However, in order to be able to understand characteristics of and patterns surrounding residential land sales, for example, the country of residence of those involved, the data over the medium term will need to be evaluated to ensure effective targeting.

42. In addition, the success of this option is dependent on another major assumption – that non-compliance with the proposed bright-line test will arise from a lack of information and knowledge about the tax implications of sales of residential land. There will be instances where an improved understanding of the tax rules and one's tax obligations in relation to a particular transaction may lead to higher levels of compliance. However, there will be taxpayers who, regardless of their level of knowledge, will not voluntarily comply with their tax obligations.

43. As noted in option 1, the Commissioner's standard tools for collection and enforcement in relation to general income tax liabilities are not always practical where the taxpayer has limited or no presence in New Zealand. As a result, withholding taxes are commonly imposed in other situations where there is the possibility of unenforceability or evasion of a tax liability, before the payee receives the income. Withholding taxes are important in these situations because they ensure that the relevant tax is paid out of the amount due to the payee before the payee gets control of the funds. This is discussed in further detail in the section titled *Status quo and problem definition*. However, in the case of residential property sales, the Commissioner's current tools for collection and enforcement do not include a withholding tax.

44. Option 2 is not preferred. As noted in option 1, the absence of a withholding tax would make the tax system less coherent as a whole given that withholding taxes are required in relation to other forms of income in similar circumstances (that is, where a payee is likely to have a tax liability and where there may be enforceability or evasion concerns). Further, while option 2 may assist in increasing taxpayers' awareness and understanding of their tax obligations in relation to residential property sales, it will not increase compliance with the proposed bright-line test in instances where voluntary compliance is unlikely to occur regardless of the extent of taxpayer education. It would also require the use of Inland Revenue resources to implement.

Option 3: status quo, but assess levels of compliance with the bright-line test in three to four years

45. This option is also similar to option 1 in that it relies on the Commissioner's existing powers for collection and enforcement and the standard "business-as-usual" response to new legislation, but it also introduces an explicit requirement that the effectiveness of the proposed bright-line test be reviewed in three to four years (when it is expected that those who purchased on 1 October 2015 or shortly after, and sold at or prior to the two-year mark, to file their income tax return).

46. Some submissions on the officials' issues paper *Residential land withholding tax* expressed concern that until Inland Revenue has undergone its Business Transformation Programme, it would be unable implement an effective and efficient withholding tax. These submissions therefore recommended delaying the implementation of a withholding tax on income derived from sales of residential property, and Inland Revenue should first conduct a review of the effectiveness of the proposed bright-line test.

47. The review of the effectiveness of the proposed bright-line test under this option would involve analysing data on land sales collected under the new Land Transfer Amendment Act 2015 and the Tax Administration Amendment Act 2015 and identifying areas of risk and non-compliance. Identification of specific areas of non-compliance would allow for better targeting of Inland Revenue's resources.

48. In addition, the resulting analysis could assist in determining whether a separate regulatory response to optimise the effectiveness of the proposed bright-line test is, in fact, required. It may also provide useful information for shaping the scope of any regulatory response, such as a withholding tax, which has been identified as a feasible option in options 4(a) and 4(b).

49. One advantage of this approach is that it may turn out that the Commissioner's current powers for collection and enforcement are sufficient in ensuring high levels of compliance with the proposed bright-line test. Conversely, if there are low levels of compliance with the proposed bright-line test, the Commissioner will need to rely on her existing tools and powers to remedy the non-compliance in the period prior to the review, and a regulatory response would also need to be subsequently designed.

50. As noted in options 1 and 2, the Commissioner's standard tools for collection and enforcement in relation to general income tax liabilities are not always practical where the taxpayer has limited or no presence in New Zealand. As a result, withholding taxes are commonly imposed in other situations where there is the possibility of unenforceability or evasion of a tax liability, before the payee receives the income. Withholding taxes are important in these situations because they ensure that the relevant tax is paid out of the

amount due to the payee before the payee gets control of the funds. This is discussed in further detail in the section titled *Status quo and problem definition*. However, in the case of residential property sales, the Commissioner's current tools for collection and enforcement do not include a withholding tax.

51. As noted in option 1, the absence of a withholding tax would make the tax system less coherent as a whole given that withholding taxes are required in relation to other forms of income in similar circumstances (that is, where a payee is likely to have a tax liability and where there may be enforceability or evasion concerns). Given the structural inconsistency with other types of income that this would create, and the apparent low levels of compliance with the current land rules to date in relation to residential property, option 3 as a "wait and see" type approach is not Inland Revenue's preferred option. This is because it would likely shift the problem to a later date and require the use of the Commissioner's resources to collect unpaid amounts of tax that arose in the review period.[2] Inland Revenue's preference is to optimise the effectiveness of the proposed bright-line test as soon as the new rules take effect. Like options 1 and 2, the "wait and see" strategy of option 3 may undermine the integrity of the tax system if there is a public perception that foreign investors, particularly in residential property, are not paying their "fair share of tax" in New Zealand.

Option 4: introduce a withholding tax on sales of residential property ("residential land withholding tax" or "RLWT")

52. This option would introduce a withholding tax on sales of residential land ("residential land withholding tax" or "RLWT") where the seller acquires the property on or after 1 October 2015 and has subsequently disposed of the property within two years. The meaning of "residential land" and how the two-year ownership period is calculated would directly follow the proposed bright-line test.

53. As noted in the section titled *Status quo and problem definition*, an important feature of New Zealand's tax system is the existence of withholding taxes on many types of income where there is likely to be a tax liability and the possibility of unenforceability or evasion. In these situations, it is likely that the payee will have a New Zealand tax liability in relation to the income they receive, and tax is accordingly withheld before the payee receives the income.

54. With the proposed introduction of the bright-line test, it highly likely that sellers who sell residential property within two years will have a tax liability in New Zealand in relation to income from that property. As noted, the Commissioner's standard tools for collection and enforcement in relation to general income tax liabilities are not always practical where the taxpayer has limited or no presence in New Zealand. In the case of bright-line sales made by overseas sellers, it would be consistent with New Zealand's broader approach to withholding taxes to withhold tax from the amount received by the seller.

55. As New Zealand currently only taxes the disposal of land in very limited circumstances, there has been no imperative to have a withholding tax on property-related transactions. Further, because under current law tax is generally imposed only when certain intention tests are met, it would be practically difficult to identify situations where tax should be withheld.

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[2] As discussed in option 1, there are likely to be limits to the effectiveness of the Commissioner's abilities to collect these tax debts when the taxpayer has no or very limited presence in New Zealand.

56. In situations when tax is likely to be imposed on income from a disposal (such as where there is a broader capital gains tax), many countries consider withholding taxes on sales of real property to be an effective collection mechanism. Countries with property withholding taxes include Canada, Japan, and the United States. In addition, Australia has recently announced that it is introducing a withholding tax on sales of certain interests in land by foreign investors to support its capital gains tax.

57. The RLWT would require the seller's conveyancer or solicitor involved in the conveyancing process (the withholding agent) to withhold an amount from the proceeds of the sale before the funds are released to the seller. The withholding agent would then be required to pay this amount to Inland Revenue.

58. The RLWT has been designed as a collection mechanism for the bright-line test, which means that RLWT is a non-final withholding tax and the seller would be able to offset the amount of RLWT withheld against their income tax liability arising under the land sale rules. If the amount of RLWT withheld exceeds their final income tax liability, they would be entitled to a refund.

59. Two separate approaches have been identified under option 4. Option 4(a) restricts the application of the RLWT to instances where the seller is an offshore person. Option 4(b) would apply to all sellers regardless of their offshore status. Under both options, there would be an exemption for transfers of inherited property or property transferred under a relationship property agreement.

60. Changes to Inland Revenue's systems would be required to implement options 4(a) and 4(b). These options would impose additional compliance costs on taxpayers selling residential property, and would incur administrative costs. The administrative and compliance costs of 4(b) are likely to be higher than option 4(a), for the reasons discussed below.

61. The extent to which the two approaches under this option meet the objective of supporting the integrity of, and optimising compliance with, the bright-line test is dependent on a number of key design features. These key design issues are considered in further detail in the section titled *Further analysis of option 4 - detailed design issues*.

Option 4(a): applies to sellers who are offshore persons

62. As noted in the discussion on options 1–3, the Commissioner's existing tools are not always practical or effective when the taxpayer has limited or no presence in New Zealand. Other areas of the income tax rules currently recognise this practical concern and use a withholding tax to assist in the collection of taxes where there is likely to be a tax liability and where there may be issues with enforceability or evasion.

63. New Zealand imposes withholding taxes on many types of New Zealand-sourced income derived by non-residents. For example, non-resident withholding tax (NRWT) is imposed on certain types of passive income such as dividends and royalties, and a form of withholding tax called "schedular payments" is imposed on non-residents performing a contract activity. These withholding taxes are imposed on the payer, who is usually resident in New Zealand, which makes enforcement and collection easier.

64. The RLWT proposed under option 4(a) would only apply where the seller is an "offshore person", a concept introduced in the Tax Administration Amendment Act 2015. In response to submitters' concerns relating to the difficulties of establishing whether a person is an offshore person (particularly relating to non-individuals), it is proposed that the definition be modified to be simpler and more prescriptive. In particular, the requirements in relation to trusts have been made clearer.

65. An individual is an offshore person if they are not a New Zealand citizen who has been physically present in New Zealand within the previous three years or a holder of a residence class visa who has been physically present in New Zealand in the previous year. It is proposed that a non-individual will be an offshore person if, in the case of a company, any of its directors are offshore persons, it is constituted outside New Zealand, or 25% or more of shareholders are offshore persons. This is broadly based on definition of "overseas person" in the Overseas Investment Act 2005, which provides for the screening and consent of proposed overseas investment in sensitive New Zealand assets, with modifications. It is also proposed that a partnership will be an offshore person if any of its partners are offshore persons. A trust will be an offshore person if any of its trustees or settlors are offshore persons. In addition, a trust will be an offshore person if all its beneficiaries are offshore persons, or if at least one beneficiary is an offshore person and has received a distribution from the trust within the last six years. For further discussion on this issue refer to paragraphs 103–118.

66. Given the general difficulty faced in collecting tax from foreign investors and other non-residents with limited presence in New Zealand, the introduction of a withholding tax under option 4(a) is Inland Revenue's preferred approach. To minimise some of the potential compliance costs under this option, particularly those borne by withholding agents, some-self certification may be required by sellers regarding whether or not they are an offshore person.

67. This option does not explicitly provide for the main home exception available under the proposed bright-line test. However, the main home exception would not apply to most offshore persons anyway, so withholding under this option where no tax liability exists is unlikely to occur.

68. While we see this option as increasing the effectiveness of the bright-line test by increasing compliance with the new rules and other options may also do the same, we also view this option as *optimising* compliance with the bright-line test, due to its impact on fairness as well as compliance and administrative costs. The compliance costs of the withholding tax under this option would legally fall on the person with the ultimate tax liability, i.e. the seller. As the withholding tax under this option would only apply to offshore persons, it is expected to increase the perception that foreign investors are paying their "fair share of tax" in New Zealand, thereby enhancing the integrity of the tax system.

Option 4(b): applies to all sellers regardless of offshore status

69. We identified option 4(b) as a possible option – a withholding tax as outlined in option 4(a), but applying regardless of the offshore status of the seller.

70. Officials consider that this would be the most effective way of ensuring maximum compliance with the proposed bright-line test. Another advantage of this approach is that it would reduce some compliance costs, as there would be no determination required as to whether a person is an offshore person or not.

71. However, we would expect overall compliance costs and administrative costs to increase relative to option 4(a). This is because there would be a greater number of transactions that require withholding. The number of sales likely to be affected is unknown, because there will be a number of behavioural effects associated with the introduction of the bright-line test, which are inherently difficult to quantify – one of these is the number of sales that would be delayed in order to exceed the two-year holding period.

72. Income from many of these sales will be exempted under the bright-line proposal because they relate to the seller's main home. Accordingly, tax would be more likely to be over-withheld under option 4(b). This would increase compliance costs as such taxpayers would need to apply for refunds. It would also increase administrative costs, because Inland Revenue would need to process these refunds.

73. It may be possible to develop exemptions that relate to the main home to address situations of over-withholding. These exemptions would need to be clear and robust and would take more time to work through than is possible under current timeframes. Any such exemptions would increase the complexity of the rules.

74. While Inland Revenue is able to implement a withholding tax under option 4(a), implementation solutions are restricted by Inland Revenue's ability to make significant systems changes ahead of the appropriate phase of its Business Transformation Programme. This means that it would be very difficult for Inland Revenue to implement and administer a withholding tax on all sales of residential property made within two years of acquisition.

75. Thus, option 4(b) is not recommended at this point in time.

Summary of analysis of options

76. The table below summarises the impact analysis of the identified options.

Option	Meets objective?	Impacts					Net impact
		Fiscal	*Economic*	*Administrative*	*Compliance*	*Fairness*	
Option 1: status quo	Does not optimise effectiveness or support the integrity of the bright-line test.	N/A	Could be perceived as inaction and increase non-compliance with New Zealand's tax rules more generally.	Would require the use of Inland Revenue resources to identify and investigate non-compliance.	This option does not impose additional compliance costs beyond those already experienced.	Could be perceived as being unfair, if there is a view that foreign investors are not paying "their fair share of tax".	Perception of unfairness could undermine the integrity of the New Zealand tax system. Does not impose additional compliance costs, but does not increase the effectiveness of the bright-line test and will require the use of Inland Revenue to investigate non-compliance. **Not recommended**
Option 2: status quo + additional information campaigns	May partially meet objective as it could increase the effectiveness or support the integrity of the bright-line test in some situations. However, the effectiveness of the bright-line test would not be optimised.	N/A	Could be perceived as inaction and increase non-compliance with New Zealand's tax rules more generally.	Would increase administrative costs as it will require the use of additional Inland Revenue resources to engage in information campaigns. Audit resources still required to investigate non-compliance.	Compliance costs may be greater than under option 1, depending on whether third parties would be required to provide information to residential property buyers and sellers about their tax obligations.	Could be perceived as being unfair, if there is a view that foreign investors are not paying "their fair share of tax".	Increases administrative costs without guaranteeing an increase in compliance. Perception of unfairness could undermine the integrity of the New Zealand tax system. **Not recommended**

Option	Meets objective?	Impacts					Net impact
		Fiscal	*Economic*	*Administrative*	*Compliance*	*Fairness*	
Option 3: status quo + review in three to four years	Does not optimise the effectiveness or support the integrity of the bright-line test.	N/A	Could be perceived as inaction and increase non-compliance with New Zealand's tax rules.	Could increase administrative costs as it will require the use of Inland Revenue resources to conduct a full review and would still require use of Inland Revenue resources to investigate non-compliance.	Compliance costs are likely to be the same as option 1.	Could be perceived as being unfair, if there is a view that foreign investors are not paying "their fair share of tax".	Perception of unfairness could undermine the integrity of the New Zealand tax system. Perception of inaction could encourage further non-compliance. **Not recommended**
Option 4(a): withholding tax on sales of residential property made within bright-line period by offshore persons	Meets objective.	The bright-line test is estimated to raise an additional $5 million per annum. As option 4 has been designed as a collection mechanism for the bright-line test, it is expected that it would raise a portion of the $5 million estimated for the bright-line test.	Would reduce instances of non-compliance with the bright-line test. Could prevent some property transactions from being completed, due to, for example, cash-flow issues, or if some sellers would in absence of a withholding tax think that they could evade the bright-line test.	Increases administrative costs because it requires the implementation of a new withholding tax type, but it could decrease required audit resources over the longer term.	Increases compliance costs in determining whether withholding applies and undertaking the withholding. Could decrease compliance costs for some sellers, where the withholding is close to their income tax liability.	Could be perceived as being fairer by New Zealand residents, if there is a view that foreign investors are not complying with their tax obligations.	Increases compliance costs and administrative costs beyond the status quo, but this is offset by reduced administrative costs in other areas and would improve integrity in the tax system, as New Zealand-based taxpayers could perceive the measure as ensuring that foreign investors "pay their fair share of tax". **Recommended**

Option	Meets objective?	Impacts					Net impact
		Fiscal	*Economic*	*Administrative*	*Compliance*	*Fairness*	
Option 4(b): withholding tax on all sales of residential property subject to bright-line test	Maximises compliance with and supports the integrity of the bright-line test, but does not optimise the effectiveness of the rules.	Would collect a greater portion of estimated bright-line revenue than option 4(a) – possibly close to the $5m bright-line estimate	Would significantly reduce instances of non-compliance. Could prevent some property transactions from being completed, due to, for example, cash-flow issues, or if some sellers would in absence of a withholding tax think that they could evade the bright-line test.	Substantially increases administrative costs and may not be possible for Inland Revenue to implement prior to relevant phase of its Business Transformation Programme.	Increases compliance costs as withholding agents will be required to withhold on all bright-line transactions. This will result in over-withholding in a greater number of circumstances, which would result in higher compliance costs.	Likely to be perceived as fair to the extent that it correctly withholds tax. Likely to be perceived as unfair if it withholds tax in situations where there is no underlying tax liability.	Substantially increases administration and compliance costs relative to status quo. While it would maximise compliance with the bright-line test, the additional administrative and compliance costs relative to option 4(a) would not be justified by the expected marginal increase in compliance. **Not recommended**

Further analysis of option 4 - detailed design issues

77. As noted above, the extent to which option 4 meets the objectives depends on a number of detailed design features of the RLWT. These detailed design issues require separate impact analysis and this analysis is summarised below.

78. These key design features were areas we consulted on as part of the submission process for the officials' issues paper and submitters' views have been taken into account in our recommendations as they provided valuable feedback on the compliance burden likely to occur with each feature and option.

The RLWT withholding rate

79. The officials' issues paper proposed a "lower of" approach, whereby the amount of the RLWT to be withheld would be the lower of 10% of the total sales price ("the default rate") and 33% of the seller's gain (i.e. total sales price - seller's acquisition price) ("the standard rate"). In most cases, we would expect the standard rate to apply, but the default rate acts as a back stop to prevent significant over-taxation where the seller's acquisition price is unable to be obtained.

80. We recommend that the "lower of" approach proposed in the issues paper be used as it strikes a balance between creating a collection mechanism that approximates the amount of tax payable under the bright-line test and making the process straightforward for the withholding agent, while also reducing the risk of significant over-taxation.

81. Ideally, the RLWT should neither under nor over tax the seller. However, for the RLWT to retain simplicity and reduce the compliance burden faced by taxpayers, the amount withheld will not be exactly the same as the seller's ultimate income tax liability. As discussed previously, the Commissioner's powers for enforcement and collection can be limited in some situations, and for this reason, we recommend that the RLWT should be more likely to over tax rather than under tax. As a result, the standard rate proposed in the issues paper used the top marginal tax rate of 33% (which is consistent with the default resident withholding tax rate on dividends where no tax rate has been provided) rather than the lowest marginal tax rate of 10.5%, for example.

82. During consultation, it was raised by some submitters that a 33% rate would always result in over-taxation in relation to sellers that are companies; they suggested a 28% rate would be more suitable. Officials agree and recommend that where the seller is a company, the standard rate should be 28% x the seller's gain.

83. To mitigate the risk of over-taxation and potential cash-flow issues for sellers, we recommend that sellers should be able to file an interim income tax return following the payment of RLWT to the Commissioner in order to obtain a refund, rather than having to wait to until the end of the income year. Submitters considered this to be an important factor in making the withholding tax practical and effective.

Options	Advantages	Disadvantages
10% of total sales price	Simple to calculate as the total sales price would be available to both buyer and seller, as well as their respective conveyancing agents thereby reducing	Likely to result in over-taxation relative to the taxpayer's final income tax liability - particularly as the bright-line test (and thus the RLWT) is targeted at short-term speculation. Where the

	compliance costs.	seller has made a loss on the sales price, RLWT would be withheld even though there is no tax liability. Would require more refunds to be issued.
	Recommendation: not recommended.	
33% of seller's gain (total sales price - seller's acquisition price)	The amount withheld would be more in line with the taxpayer's final income tax liability. Relatively simple to calculate - seller's acquisition price generally available from Quotable Value. No RLWT to be withheld when the seller has made a loss on the sales price.	There may be instances where the seller's acquisition price is not available, in which case, 33% x seller's gain becomes 33% x total sales price and there would be over-taxation. Over-taxation would also occur where the seller has a number of deductions available (for example, where the seller has made a number of capital improvements)
	Recommendation: not recommended.	
"Lower of" approach	The amount withheld would be more in line with the taxpayer's final income tax liability, but there is a back stop where the seller's acquisition price cannot be obtained.	There would still be some instances of over-taxation where the seller has a number of deductions available.
	Recommendation: recommended.	

The withholding agent

84. In general, withholding taxes are used to ensure that the relevant tax is paid out of an amount due to a person before the recipient gets control of the funds. The recipient may have an incentive to spend the funds before tax has been paid, which is generally why tax administrations "clip the ticket" before the money reaches the recipient. In finding an appropriate party to clip the ticket, we consider it should be the person with the least to gain from failing to comply with the rules – this is normally the payer of the amount. This is particularly relevant to the problem here, because the RLWT under option 4 is aimed at enforcing the seller's tax liability under the bright-line test, where the seller may not otherwise comply with their tax obligations.

85. The officials' issues paper proposed that the withholding agent should be a solicitor or conveyancer involved in the property conveyancing process ("the conveyancing agent") and not the buyer or seller themselves.[3] This is because they already have professional obligations to discharge in relation to the conveyancing of property and this would more naturally form part of those other obligations. They also have the systems and trust accounts needed to manage the funds involved in the settlement of property, which is important in terms of ensuring the integrity of the withholding process.

86. The majority of submitters agreed that neither the buyer nor seller should be the default withholding agent and proposed that the seller's conveyancing agent should be the withholding agent. This is because they have ready access to the required information to determine whether the seller would be eligible for an exemption from withholding and it would minimise the required interaction between the buyer's and seller's conveyancing agents. This reduces the compliance burden imposed on the conveyancing agents and their clients. In addition, a major advantage identified by submitters was that it would make the

[3] However, many other countries place the withholding obligation on the buyer, but they expect the buyer to use the services of a solicitor to discharge their withholding obligations.

withholding tax a lot fairer – the compliance costs of the withholding tax would be borne by the seller.

87. Officials do not consider the issue to be as clear cut. There are a number of advantages to requiring the buyer's conveyancing agent to withhold on the buyer's behalf. The first is that it follows other withholding taxes (both in New Zealand and overseas), where the withholding agent is the first payer in the chain. Other advantages include that a secondary obligation can be placed on the seller's conveyancing agent if the buyer's agent fails to withhold, the funds are more likely to flow through a New Zealand bank account, and it would not create a potential conflict between the seller and their conveyancing agent where withholding could go against a client action.

88. Officials consider the advantages and disadvantages of both options to be finely balanced. There are marginal compliance cost benefits to the proposal that the withholding agent be the seller's conveyancing agent. On the other hand, there are marginal revenue integrity benefits to the proposal that the withholding agent be the buyer's conveyancing agent.

89. Officials consider that the better approach, on balance, is the proposal that the withholding agent be the seller's conveyancing agent as long as sufficient other revenue integrity measures can be put in place as part of the overall structure of the proposed RLWT.

90. Where the buyer is the withholding agent, we recommend that they should be required to provide a statutory declaration stating they have fulfilled their withholding obligations. We consider this necessary to protect the integrity of the RLWT. We understand that while it is possible to complete a property transfer without a conveyancing agent, only very few people do. RLWT should not encourage people to undertake their own conveyancing simply in order to circumvent the application of the withholding tax.

Options	Advantages	Disadvantages
Buyer	Legal international norm e.g. US, Canada, Japan (and soon Australia). Allows the buyer to use their solicitor to discharge their withholding obligation if desired.	Would be administratively burdensome for Inland Revenue and compliance-heavy for buyers of residential property.
	Recommendation: not recommended.	
Buyer's conveyancing agent (e.g. solicitor or conveyancer)	Practical international norm e.g. US, Canada, Japan (and soon Australia), where buyers are expected to use a solicitor or other agent to discharge their withholding obligations. Follows other New Zealand withholding taxes which place withholding liability on the payer (e.g. employers with PAYE, banks with RWT and NRWT). There is a "back stop": if the buyer's conveyancing agent fails to withhold correctly, a secondary liability can be placed on the seller's conveyancing agent.	Seen as unfair as the ultimate tax liability belongs to the seller. Requires the buyer's conveyancing agent to obtain information about the seller from the seller's agent, which could lead to delays in settlement. May be seen as increasing the compliance burden on the buyer's agent and adding an additional cost to New Zealand buyers.
	Recommendation: not recommended.	
Seller's conveyancing agent (e.g. solicitor or conveyancer)	Could be seen as being fairer for buyers – the compliance burden and cost are legally borne by the seller (i.e. by the person with the ultimate tax liability). The seller's conveyancing agent may have more immediate access to information about the seller's offshore status. The seller's conveyancing agent deals with other expenses at the time of settlement (e.g. mortgages and	Contrary to international norms and New Zealand's current withholding taxes where the withholding liability on the payer. There is no "back stop" if the agent fails to withhold.

	rates).	
	Recommendation: recommended if a number of safeguards are introduced to protect the integrity of the withholding tax.	

When should the Commissioner be paid before other disbursements?

91. In situations where the buyer's conveyancing agent withholds RLWT, the amount withheld would be paid to Inland Revenue and the remaining funds would then be passed to the seller's conveyancing agent, who would use the funds to pay the seller's mortgages and outstanding local government rates, before paying the remaining amount to the seller.

92. Where the seller's conveyancing agent withholds RLWT, the issue of whether the withholding tax should be paid first (that is, before mortgages on the property) arises.

93. The issues paper proposed that the Commissioner should be paid before other disbursements.

94. If withholding tax is collected first, this would be consistent with the situation where the buyer's conveyancing agent withholds RLWT. It also provides the same result as other withholding taxes such as PAYE, as tax is withheld by the payer before the payee receives the balance.

95. If withholding tax is not collected first, there would be an incentive for an offshore seller to effectively strip out the profits from the sale by increasing their mortgage prior to the sale in order to avoid payment of RLWT. This may be particularly problematic where the mortgagee is an overseas lender, as in those situations, New Zealand Reserve Bank lending ratios will not be relevant.

96. Where there is a resulting unpaid tax liability, this behaviour could be subject to penalties for tax evasion. However, because the offshore person is unlikely to have any presence in New Zealand, the Commissioner would need to rely on the existing rules for collecting tax. Under these rules it is more difficult to collect tax from offshore persons. Accordingly, if RLWT is not collected in these situations then the objective of the RLWT rules is significantly undermined.

97. Therefore Inland Revenue's preferred approach is for the Commissioner to be paid before other disbursements, as it is (in substance) consistent with other withholding taxes and it would be the most effective approach from an integrity perspective.

98. However, submitters on the officials' issues paper considered that the Commissioner should not be paid before the seller's other creditors. Their reasons centred on the fact that it could leave insufficient funds to discharge the seller's mortgage, resulting in delays in settlement, or prevent settlement from occurring in some cases. Submitters also noted that income tax does not usually have priority in circumstances of liquidation. However, officials consider that the better comparison in this context is with other types of withholding taxes, which are paid first.

99. Officials were asked to consider alternative options to address submitters' concerns while still providing an acceptable level of integrity.

100. An option suggested by one submitter was for RLWT to be paid first, but the mortgagee releases title on the basis that when the seller's ultimate tax liability in relation to the sale is calculated, Inland Revenue could repay the amount of overpaid tax directly to the mortgagee.

Under this approach, the mortgagee would effectively step into the shoes of the seller. This could involve relatively high administrative and compliance costs. There would need to be criteria for Inland Revenue to determine whether the refund should be provided to the mortgagee, for example, on the basis that the seller has no ultimate tax liability, or that Inland Revenue has determined that there is no abuse. Further, it may be difficult to implement as the mortgagee may not have sufficient information about the seller in order to claim the refund from Inland Revenue.

101. Officials considered whether specific anti-abuse rules could target avoidance situations, for example, requiring RLWT to be paid before other disbursements where the seller has deliberately geared up prior to the sale or has an arrangement with an associated party. Any anti-abuse rules would need to be applied by the withholding agent rather than by Inland Revenue, so from a practical perspective, the rules would need to be straightforward and able to be easily determined.

102. To address to an extent the concerns raised by submitters in relation to delays in settlement (or non-settlement), it is proposed that the Commissioner should be paid before other disbursements unless the disbursement relates to a mortgage held by a New Zealand-registered bank (or a New Zealand-registered non-bank deposit taker). Officials consider that this rule should provide a reasonable level of integrity as priority would apply in situations where abuse is particularly likely to occur. This rule should also be relatively straightforward for withholding agents to apply.

Definition of offshore person/information requirements

Individuals

103. For individuals, an offshore person (as defined in the recently enacted Tax Administration Amendment Act 2015) is a person who is:

- not a New Zealand citizen or does not hold a New Zealand residence class visa; or
- a New Zealand citizen and has been away from New Zealand for more than three years; or
- a holder of a New Zealand residence class visa and has been away from New Zealand for more than one year.

104. Several submitters on the issues paper asked for further detail around what would be required to satisfy this test. We propose the following criteria.

105. The withholding agent would need to be satisfied that the seller meets the requirements for non-withholding.

106. It is anticipated that in most cases a New Zealand citizen or holder of a residence class visa who is selling within two years could satisfy the proof requirement by meeting with their New Zealand conveyancing agent in person and showing them their passport. The conveyancing agent would be able to take a copy of the documentation and record that they have seen the person in New Zealand (as the person is currently in New Zealand, this means that they will not be an offshore person).

107. If an individual person is selling their property from outside New Zealand, a certified statement or other suitable proof from the seller that they are not an offshore person should be provided to the withholding agent. This could include evidence of flights to New Zealand within the relevant time.

108. The proposed requirements for sellers to provide further information on their offshore status go beyond the recently enacted information requirements for requiring IRD numbers on property transactions as specified in the Land Transfer Amendment Act 2015. However, we consider that, in order to make the proposed withholding tax effective and to minimise compliance costs for agents, this additional information is necessary. In practice, for individuals this information would likely have been captured by conveyancing agents as evidence anyway.

Non-individuals

109. The issues paper proposed that for an entity or an arrangement (e.g. a company or a trust), an offshore person could be a person who is either incorporated overseas or who is owned or controlled (legally or beneficially) 25% or more by offshore persons. This is based on the definition of "offshore person" as defined in the recently enacted Tax Administration Amendment Act 2015.

110. Concerns were raised by submitters around the potential difficulties for withholding agents to determine whether a non-individual is an offshore person. This could be complex and involve high compliance costs if the withholding agent needs to verify the underlying ownership of an entity or trust. We also have some concerns with the 25% threshold in relation to certain arrangements (in particular, partnerships and trusts).

111. Accordingly, we consider that the test for non-individuals (including arrangements) should be modified to be more certain and to ensure revenue integrity.

112. For a company (including a unit trust) to qualify for the non-offshore exemption, the following conditions should be met:

- the company is registered in New Zealand; and
- all directors of the company are non-offshore individuals; and
- not more than 25% of the shareholder decision-making rights of the company are held by offshore persons.

113. This could be satisfied, for example, by proof such as:

- a copy of the company's New Zealand registration; and
- a copy of each director's New Zealand passport or residency visa sighted during a meeting with the conveyancing agent; and
- a statement from each director that, to their knowledge, no more than 25% of the shareholder decision-making rights of the company are held by offshore persons.

114. For partners of a partnership, we propose that if any of the partners is an offshore person, then the RLWT should apply. This will ensure integrity is retained.

115. We propose that discretionary trusts should be considered offshore and subject to RLWT if either a settlor or trustee is an offshore person (as defined above).

116. In addition, the trustees of a discretionary trust have the ability to shift the tax liability to one of the beneficiaries by distributing the income to the beneficiary and treating it as beneficiary income. In order to ensure that the gain does not escape tax by being transferred to an offshore beneficiary, the RLWT should also apply to gains of trusts where:

- all of the beneficiaries of the trust are offshore, or

- one or more of the beneficiaries are offshore, and the offshore beneficiary received a distribution from the trust within the last six years.

117. This should limit instances of abuse. At the same time, it would ensure that most ordinary family trusts that only hold the family home would not be subject to RLWT solely because some of its beneficiaries reside overseas.

118. A corporate trustee would be able to qualify for the non-offshore exemption if it met both the company and trust criteria above.

Certification

119. Pure self-certification is not recommended in this instance, due to the funds potentially at stake – the two outcomes for RLWT are withholding and no withholding, while for the majority of other withholding taxes, the two outcomes both involve withholding, but at different rates. Pure self-certification could create an incentive to fraudulently self-certify as not an offshore person, thus reducing the effectiveness of the withholding tax.

Options	Advantages	Disadvantages
Pure self-certification	From a compliance perspective, it is very simple.	Could create an incentive to fraudulently self-certify as not an offshore person due to the funds at stake. This could substantially reduce the effectiveness of the withholding tax and thus the bright-line test.
	Recommendation: not recommended.	
Provision of information by seller and certification by conveyancing agent	Could be very difficult or impractical to determine in relation to non-individuals. This would increase compliance costs substantially.	Less likely for offshore person non-individuals to be incorrectly classified. This would enhance the effectiveness of the withholding tax and bright-line test.
	Recommendation: not recommended.	
Withholding agent must be satisfied that person is not offshore, with clear guidance on who is offshore and what information is acceptable	Reduces compliance burden placed on withholding agents to determine whether a non-individual is an offshore person. The requirement that the non-offshore person who controls the entity must provide a statement in relation to the offshore status of underlying owners gives the Commissioner someone to impose penalties on if the statement is incorrect.	Would still impose compliance costs on non-individuals in order to be able to correctly state whether they are an offshore person.
	Recommendation: recommended.	

Penalties for failure to withhold

120. Penalties play an important role in ensuring that taxpayers, including withholding agents, do not have an incentive to not comply with their tax obligations. The Tax Administration Act 1994 provides for a number of monetary penalties, for example, late payment penalties and shortfall penalties.

121. To maintain overall coherence of the penalties regime, we recommended as a starting point, the existing penalties that apply to withholding regimes should apply to withholding agents who have not complied with their withholding obligations.

122. In some cases, it is possible for criminal penalties, including "absolute liability offences" to apply. For example, failing to keep documents required to be kept by tax law is an offence punishable by a fine not exceeding $12,000. During consultation, some submitters expressed concern in relation to the potential application of criminal penalties. While they agreed that monetary penalties were appropriate, they were concerned that applying criminal penalties in relatively "low level" cases could have overly severe consequences for conveyancing agents. We note that potential criminal penalties are relatively few in number, but are critical to the integrity of the tax system. They apply to all persons with tax obligations.

123. However, unlike other withholding regimes, we do not recommend also making the conveyancing agent responsible for the underlying amount that should have been withheld. This is because they are an intermediary in the process and neither the purchase amount nor sales proceeds belongs them. To do so would likely increase the cost of professional indemnity insurance, potentially substantially.

124. Other countries which place the withholding obligation on the buyer are able to hold the buyer liable for the amount that should have been withheld. However, since we are recommending a departure from that approach, we do not consider it appropriate to hold the buyer liable for the underlying amount of withholding tax that should have been withheld. A buyer would have limited ability to ensure that the seller's conveyancing agent does the right thing.

125. In addition, we consider that Inland Revenue should be able to inform the relevant professional body of the withholding agent about a failure to withhold where the failure appears to be negligent or fraudulent.

126. We also consider that the buyer should be held liable for the amount of RLWT that should have been withheld, if the buyer and seller are associated persons.

Options	Advantages	Disadvantages
Withholding agent is liable for amount that should have been withheld	There is someone in New Zealand from whom Inland Revenue can collect the amount that should have been withheld and paid to Inland Revenue.	The funds never belonged to the withholding agent – they are simply an intermediary. This may lead to increases in the cost of professional indemnity insurance, which could substantially increase the cost of conveyancing.
	Recommendation: not recommended.	
No further action	Simple to administer. Provides certainty to withholding agent that they would not be held liable for the amount that should have been withheld, if they had no reason to not believe the seller's statement.	Aside from monetary penalties there will be no incentive for withholding agents to comply with withholding tax obligations. This would undermine the integrity of the withholding tax and the bright-line test, as well as the integrity of the tax system.
	Recommendation: not recommended.	
Referral to relevant professional body after failure to withhold due to negligence or fraudulence	Similar to system in place for Landonline. Provides withholding agents with additional incentive to comply with withholding obligations, otherwise they could lose the ability to practise. Still provides withholding agents with certainty that they would not be held liable for the amount that should have	Action taken by relevant professional may not deter repeat offenders and may not affect overseas solicitors. There may still be an incentive to not comply with withholding tax obligations – particularly if the withholding agent is not a New Zealand-registered solicitor.

	been withheld if the seller misled them.	
	Recommendation: recommended.	

CONSULTATION

127. Treasury and Inland Revenue officials released an officials' issues paper titled *Residential land withholding tax* on 31 August 2015. Submissions closed on 2 October 2015 and a total of 16 submissions were received, including from those in the conveyancing industry.

128. In addition to this, a workshop was held on 10 September 2015 with representatives from the Auckland District Law Society, New Zealand Law Society, and the New Zealand Society of Conveyancers to discuss the proposals in the issues paper. The intent of the workshop was to inform submitters in compiling their written submissions and to provide officials with an indication of submitters' views prior to the receipt of written submissions.

129. Support for the proposal was mixed. While some submitters supported the proposal, other submitters submitted that the measure should not proceed if the revenue that would be directly collected by the measure is less than the potential compliance and administrative costs. Officials note that while revenue directly raised from the measure is important, a key objective of the proposed measure is to support the integrity of the bright-line test as part of the wider tax system.

130. Submissions generally focused on whether the buyer's conveyancing agent or seller's conveyancing agent should be the withholding agent and the likely compliance impacts associated with both approaches, as was requested in the issues paper. The majority of submitters expressed their preference for the seller's conveyancing agent to be the withholding agent. This is due to a number of reasons, including the fact that the seller's conveyancing agent is likely to have more detailed information about their client and that the seller's conveyancing agent deals with other disbursements at the time of settlement. Submitters raised a number of points as to why the withholding agent should not be the buyer's conveyancing agent – in particular, it would not be fair to require buyers to bear the compliance cost of withholding when it is the seller who has the ultimate tax liability and sellers may not want to disclose private information (for example, personal details about all beneficiaries of a family trust). While officials note that imposing the obligation on the buyer's conveyancing agent would not necessarily mean that the compliance costs are borne by the buyer, the points raised in the submissions have informed our analysis on who should be the withholding agent under option 4.

131. The issues paper proposed to give the Commissioner priority over other disbursements made at the time of settlement - that is, for RLWT to be paid before the seller's other disbursements. This is Inland Revenue's preferred approach, as it is (in substance) consistent with other withholding taxes and it would be the most effective approach from an integrity perspective. However, submitters did not believe that the Commissioner should be paid before other disbursements made at the time of settlement, as it could prevent some sales from being completed.

132. To address the concerns raised by submitters to an extent, it is proposed that the Commissioner should be paid before other disbursements unless the disbursement relates to a mortgage held by a New Zealand-registered bank or non-bank deposit taker. Officials consider that this rule is likely to prevent situations that are particularly problematic from an

integrity perspective, and should be relatively straightforward for withholding agents to comply with.

133. Many submitters expressed concern about the difficulty of identifying who is an "offshore person", particularly in the case of non-individuals. This may be impractical and difficult when there are many levels in the structure of a company and it is not immediately clear who the underlying owner is. This concern has been taken into account in the design of the RLWT under option 4(a). In addition, option 4(b) has also been identified and analysed as an alternative approach by subjecting all bright-line sales to the withholding tax.

134. A few submitters also raised concerns about whether Inland Revenue is able to implement a new withholding tax, given the age of Inland Revenue's current computer system and the limited ability to make changes to it before the completion of Inland Revenue's Business Transformation Programme. Some submitters proposed that the implementation of a withholding tax should be delayed until the relevant part of the Business Transformation Programme has been completed and detailed data is available on compliance with the bright-line test. Inland Revenue is able to make the appropriate systems changes to implement the withholding tax, but to address submitters' other points, we have identified as a feasible option and analysed whether a review in three to four years would meet the objective of optimising the effectiveness of the bright-line test (option 3).

135. Submitters also made comments about detailed design features of a withholding tax under option 4. We have taken these comments into consideration in our design of the policy details.

CONCLUSIONS AND RECOMMENDATIONS

136. Inland Revenue supports option 4(a). We consider that option 4(a) would optimise the effectiveness and support the integrity of the bright-line test. With the proposed introduction of the bright-line test, it highly likely that overseas sellers who sell residential property within two years will have a tax liability in New Zealand in relation to income from that property. It would be consistent with New Zealand's broader approach to withholding taxes to withhold tax on the payment received by the seller.

137. Given the general difficulty faced in collecting tax from foreign investors with no physical presence in New Zealand, we consider that options 1–3 would not improve compliance with the bright-line test and could undermine the integrity of the tax system if there is a perception that foreign investors, particularly in the area of residential property, are not paying their "fair share of tax" in New Zealand. Option 4(b) would not optimise the effectiveness of the bright-line test due to the significant additional compliance and administrative costs relative to option 4(a).

138. While option 4(a) involves greater up-front administration costs, compliance costs and is not expected to raise Crown Revenue (as it is simply a collection mechanism), we consider that it would meet the objective of optimising the effectiveness, and supporting the integrity of, the bright-line test. However, the extent to which a withholding tax would meet the objectives is dependent on the key design features we have outlined in this regulatory impact statement.

IMPLEMENTATION

139. Legislative change to the Income Tax Act 2007 and Tax Administration Act 1994 would be required to implement option 4. Any legislative amendments required to implement option 4 could be included in a bill introduced before the end of 2015.

140. The Government has indicated that a withholding tax under option 4 should be effective from 1 July 2016. To ensure that Inland Revenue has the appropriate systems changes in place and that practitioners involved in the withholding process are well informed of their obligations, any legislative amendments should be enacted by the end of March 2016.

141. In addition, Inland Revenue would be required to update forms and communication material that can be distributed to withholding agents and other parties potentially impacted by the withholding tax. One possibility would be to distribute information forms to real estate agents to distribute to their clients.

142. The withholding tax under option 4 would be administered by Inland Revenue.

143. Whilst Inland Revenue has mechanisms in place to collect various taxes, it does not have existing administrative arrangements to collect the proposed RLWT.

144. Where a withholding agent has failed to withhold when required, penalties would apply and where there has been a negligent or fraudulent failure to withhold, Inland Revenue would work closely with the relevant professional body to ensure that appropriate action is taken.

145. In designing option 4, officials sought feedback from representatives on the compliance costs associated with administering a withholding tax. This feedback informed the key design features preferred by officials as set out in the regulatory impact analysis section of this statement.

MONITORING, EVALUATION AND REVIEW

146. Inland Revenue is putting in place new systems for administering the bright-line test including a new form to monitor property sales subject to the bright-line test. In addition, further measures have been introduced to provide more useful information to Inland Revenue about land sales. These measures will enable Inland Revenue to have better information about cases where withholding tax should be withheld and whether or not it has actually been withheld.

147. If any detailed concerns are raised in relation to these changes, Inland Revenue will determine whether there are substantive grounds for review under the Generic Tax Policy Process (GTTP).

148. Inland Revenue monitors, evaluates and reviews new legislation under the GTTP. The GTTP is a multi-stage tax policy process that has been used for tax policy in New Zealand since 1995. The implementation and review stage of the GTTP involves reviewing the legislation after implementation and identifying any issues.

149. Inland Revenue officials will continue to make themselves available for discussion with affected parties in the design of a RLWT under option 4(a).