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Auckland Fabians 2021

The housing crisis, taxation policy: restoring equity to the social fabric of New Zealand

Wednesday, 28th April, 6.30-8pm,

AUT City Campus, Lecture Theatre WG126

Susan St John, University of Auckland,
and Terry Baucher, Founder Director, Baucher Consulting.

Can we agree about the problem?

- Scary housing bubble
- Real resource misallocation problem
- High rents evictions homelessness despair and social dislocation
- Unsustainable inequality

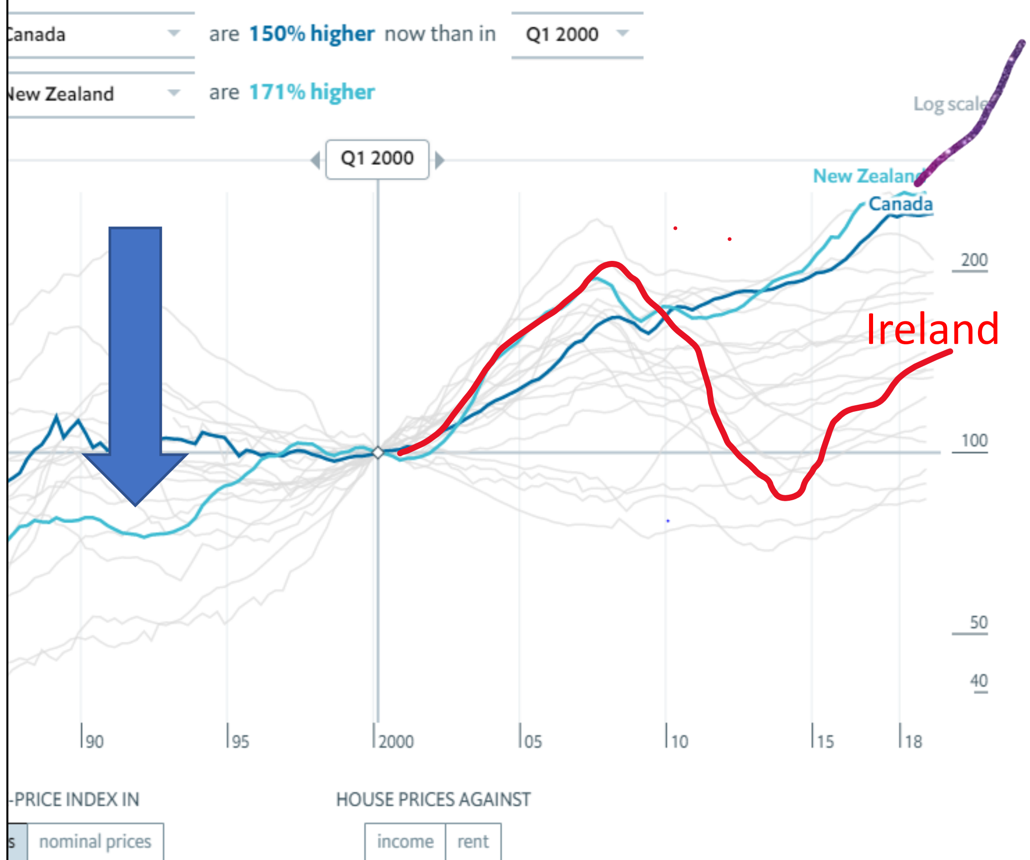
"What we really have is a serious, systemic wealth distribution issue to deal with – housing is the prism through which you see this inequality of wealth most clearly.“ Mark Todd

1. Scary bubble

" If house prices climb faster than either earnings or rent payments for a long period of time, a housing bubble may be forming.

On this basis, house prices appear to be on an unsustainable path in Australia, Canada and New Zealand.

Ten years ago they reached similarly dizzying heights against rents and incomes in Spain, Ireland and some American cities, only to endure a brutal collapse."



Betting on capital gains: housing speculation in Auckland, New Zealand

2020

Michael Rehm and Yang Yang
Department of Property, The University of Auckland, Auckland, New Zealand

The authors find that housing speculation in Auckland is endemic and its housing market is a politically condoned, finance-fuelled casino with investors broadly betting on tax-free capital gains.

International Journal of Housing Markets and Analysis © Emerald Publishing Limited 1753-8270 DOI 10.1108/IJHMA-02-2020-0010

Housing speculation

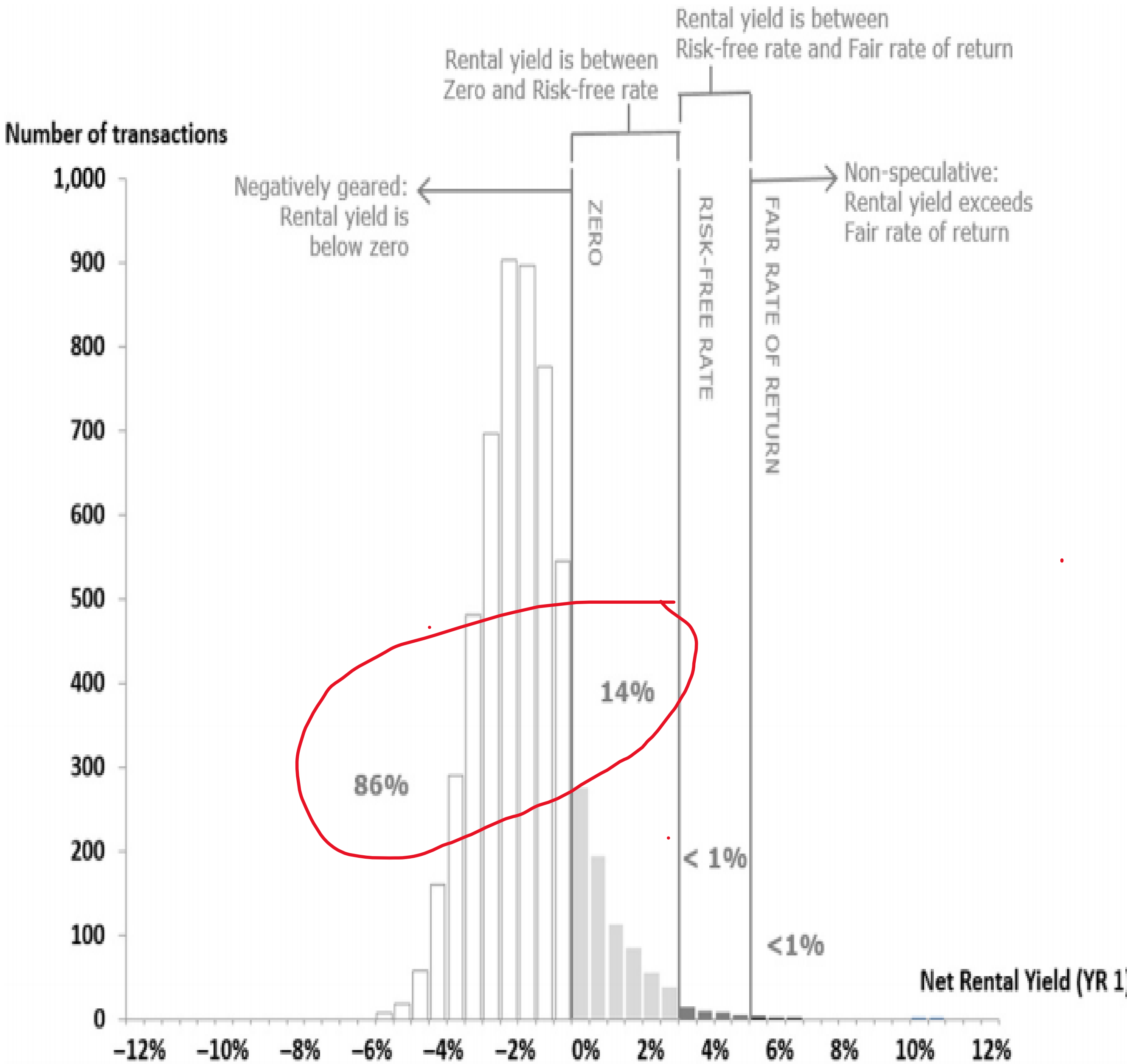
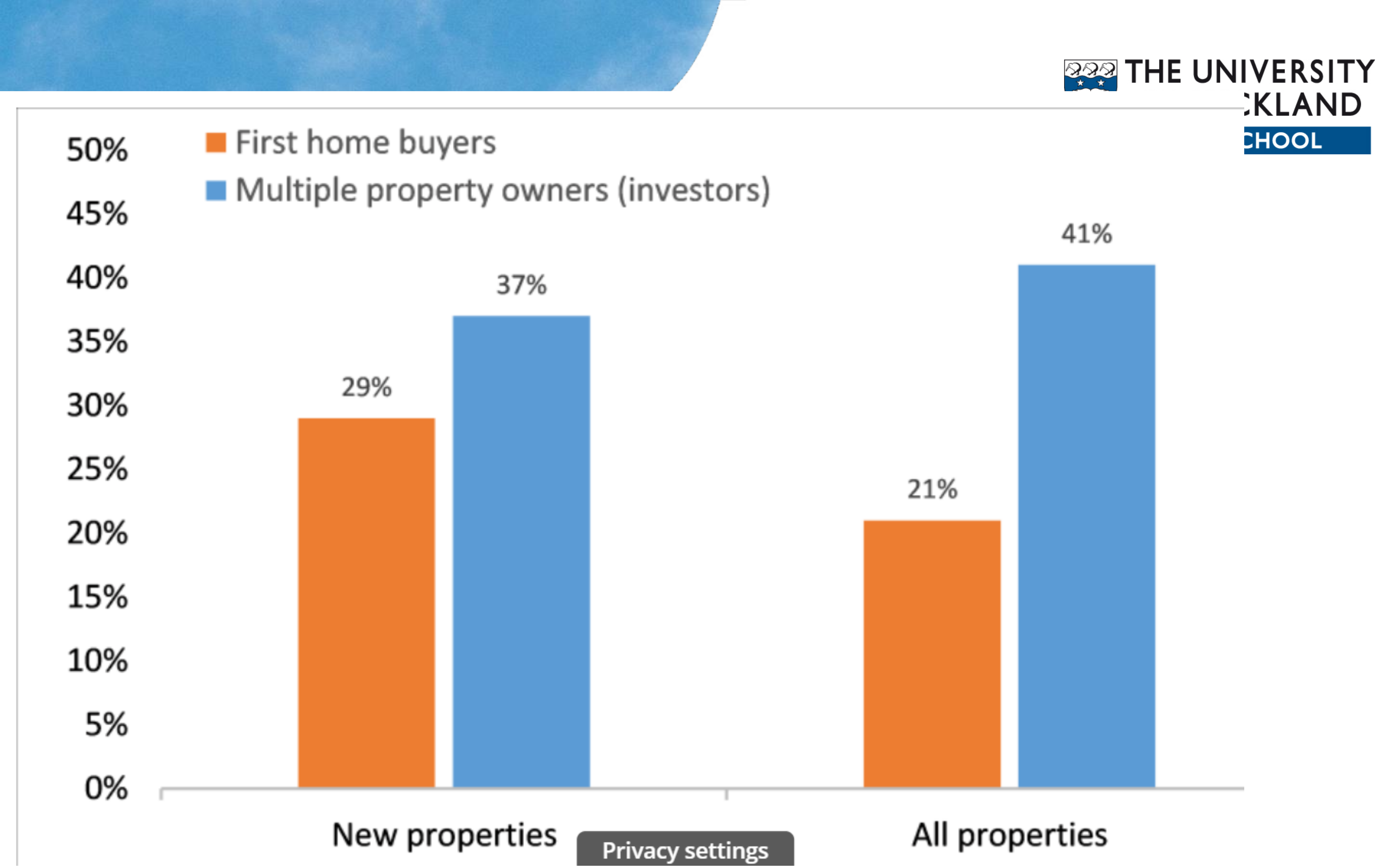


Figure 3. Histogram showing modelled rental yields of leveraged freestanding home purchases in 2016

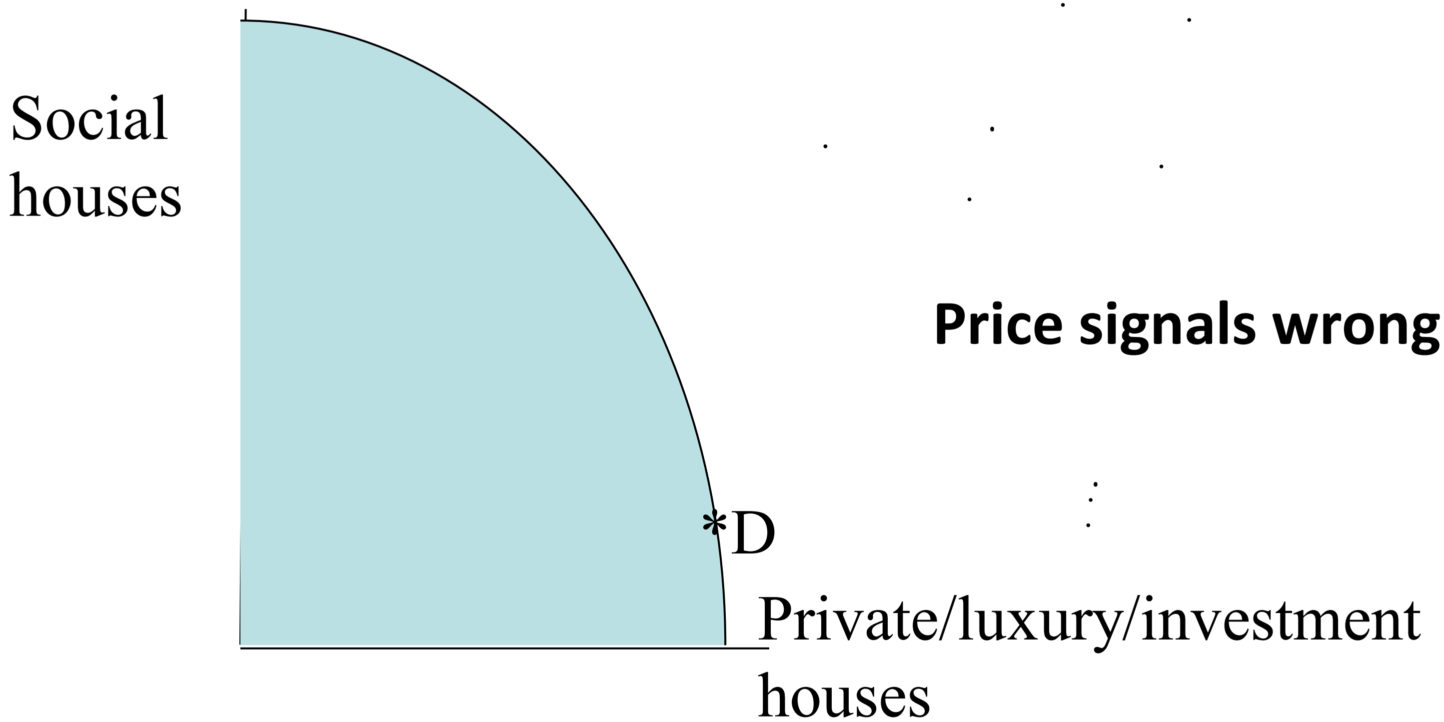
Rehm and Yang



Share of purchases Q1 2021 by buyer and property type (Source: CoreLogic)

2. Real resource problem

Using our scarce resources for things that enhance all lives now and for the future.

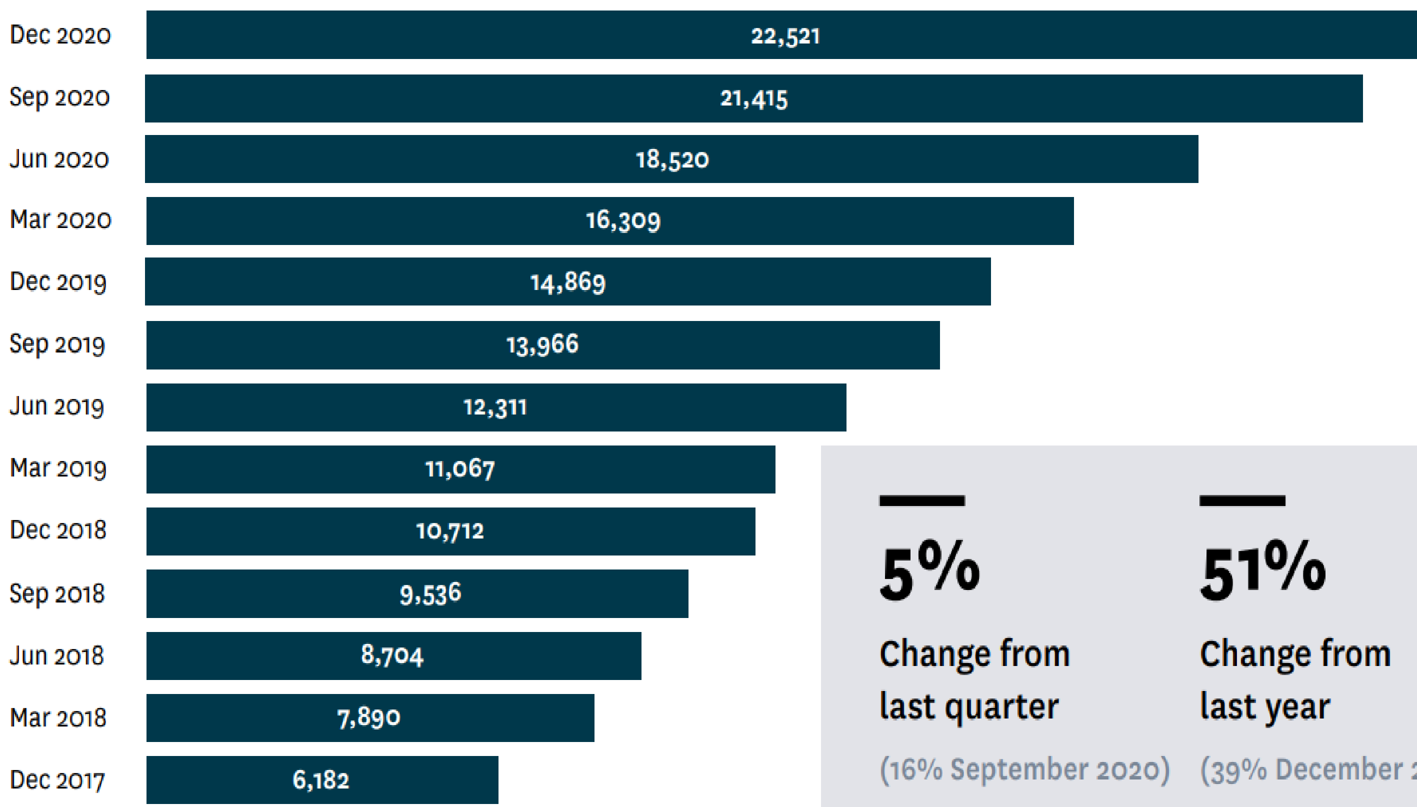


Price signals wrong

3. Accelerating Misery and degradation

Housing Register

The Housing Register captures the housing requirements of people who have applied for public housing through MSD.



5%

Change from last quarter

(16% September 2020)

51%

Change from last year

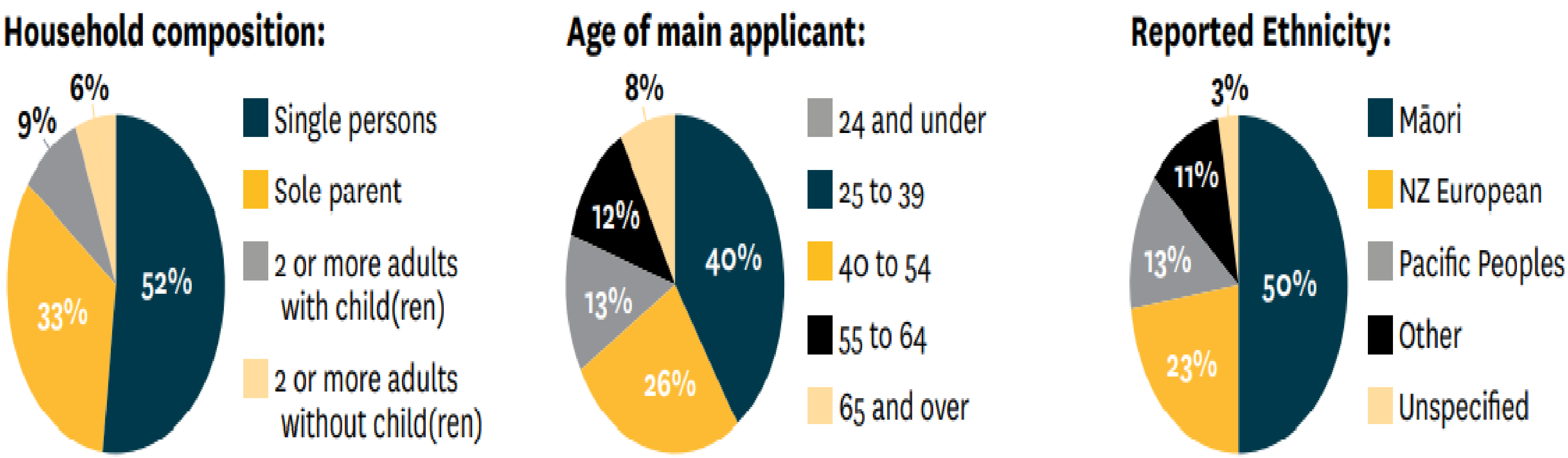
(39% December 2019)

Priority A (90%) applicants 'at risk' includes households that have a severe and persistent housing need that must be addressed immediately.

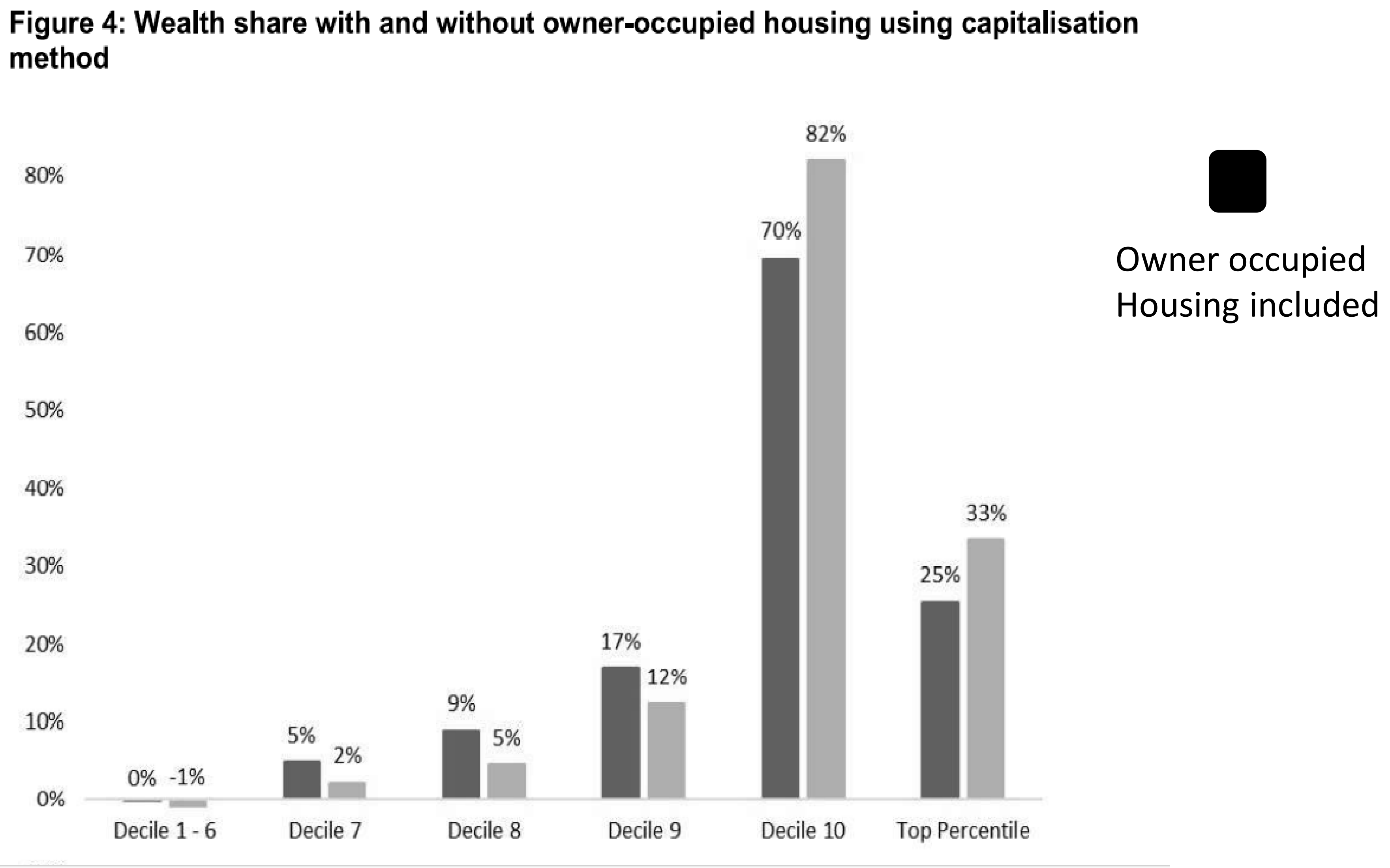
Priority B (10%) have a 'serious housing need' and includes households with a significant and persistent need

Characteristics of applicants on the Housing Register

As at the end of December 2020 the main characteristics of applicants on the register were:



4.Unsustainable, exponential growth in inequality.



Treasury 2021 estimates of wealth distribution 2016

Where is the damaging inequality?

Source
Corelogic April 2021

Emmerson: the tools for a housing emergency

Govt has been using the hose

BUT Sadly one full of petrol

- Monetary policy has inflated the property market with cheap money.
- **Housing is a taxpayer subsidised investment asset**

Bright-line test only applies to future purchase and sale–
Does not capture tax-free accumulated capital gains

Removal of interest deductibility – reduces ability to generate losses for leveraged rentals
Accrued tax losses can still be passed forward
Does not impact on 100% equity financed or owner-occupied properties

Why not a Capital Gains Tax

- CGT (if perfect) *may* achieve *horizontal equity* for future capital gains
- **No impact on wealth accumulated and compounded over years of neglect to date**
- Capital losses can be carried forward
- Requires date of valuation
- Family home exempt
- Takes years to implement
- It is off the table

Had we had a CGT in place it would have missed most of it

TY
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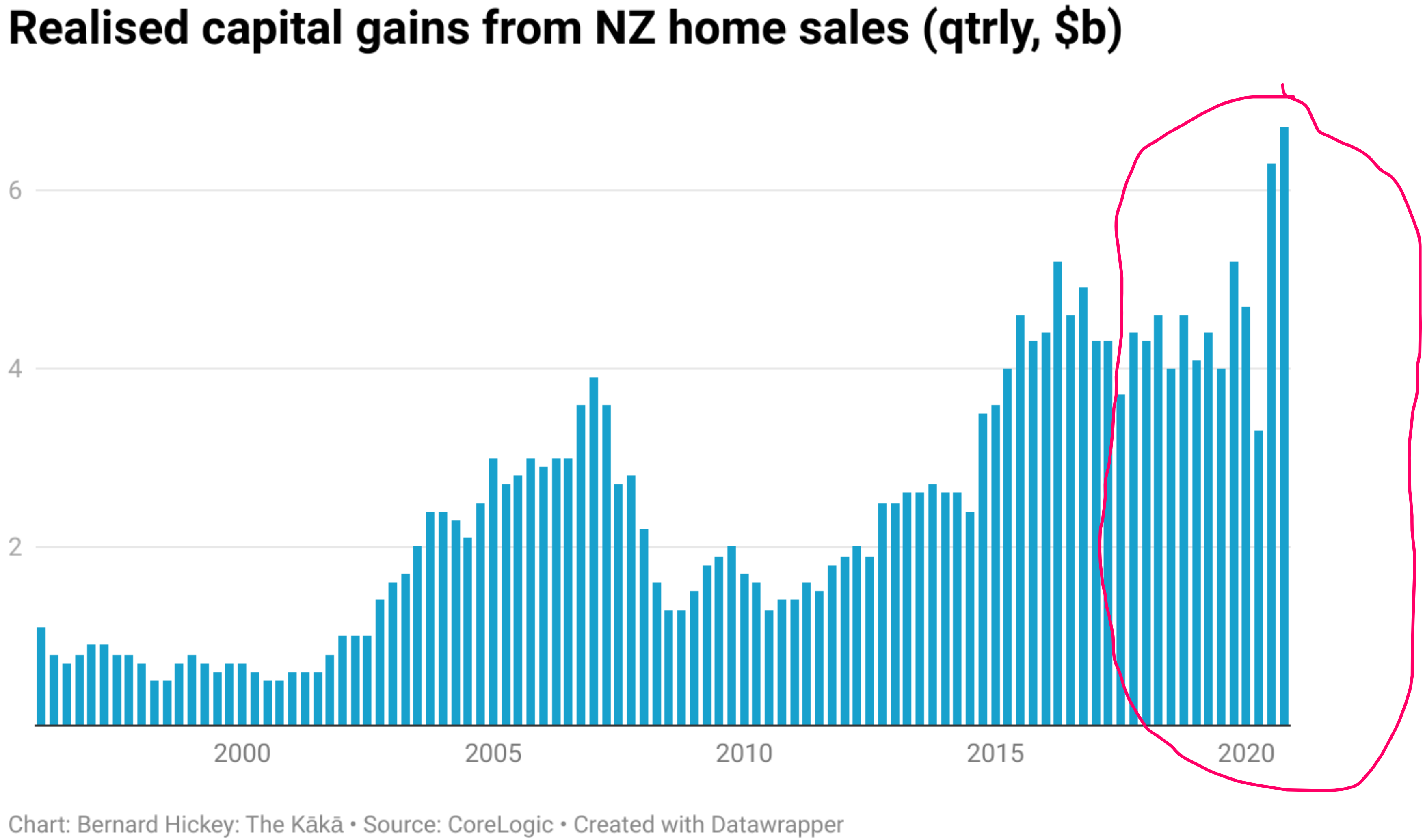
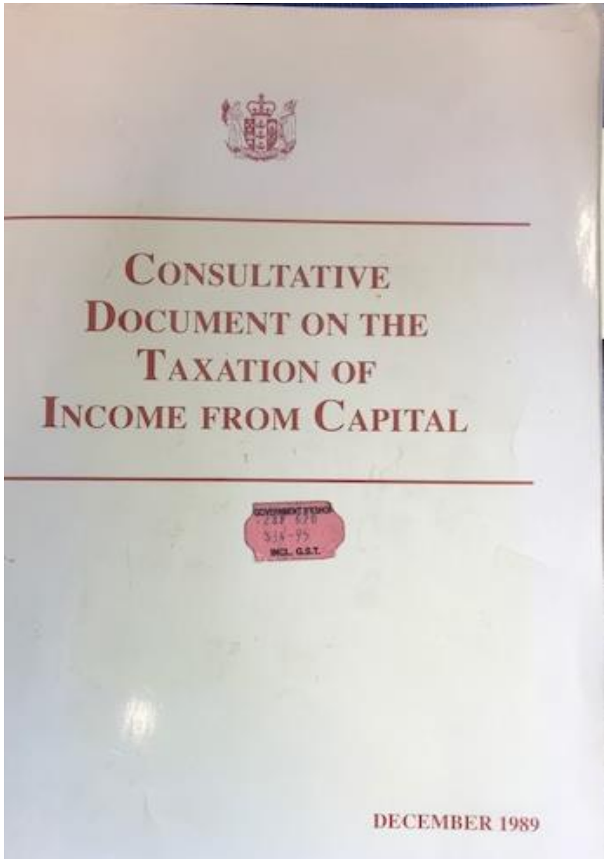


Déjà vu: the graveyard of CGT in NZ

- 1967 Ross Committee
- 1982 McCaw Committee
- 1987 Brash Consultative Committee Accrual Tax
- 1988 Valabh Consultative Committee International Tax Reform
- 1989 Report of the Consultative Committee
  Income from Capital
  - Abandoned 20th March 1990 by David Caygill
- 1988 Royal Commission Social Policy
- 1988 Brash Committee Superannuation
- 1988 Brash Committee Life insurance
- 2001 McLeod Tax Review
- 2010 Tax working group report
- 2019 TWG report



But what did govt say it wanted? the TWG were asked

- “to consider a package or packages of measures which **reduces inequality**, so that New Zealand better reflects the OECD average whilst increasing both **fairness across the tax system** and **housing affordability**".

“Somebody who goes to work every single day and pays tax on every dollar they earn can look at somebody who is speculating in the housing market and wonder why they’re not being treated fairly - we want to address that issue.”

Can we move with urgency?

Reform must

- Address the actual problem
- Remove pernicious tax distortions
- Be progressive in design
- Encourage better rental market
- Produce revenue for redistribution
- Be simple, fair and above all doable

Fair economic return FER

(Origins in RFRM- 2001, minority report TWG 2019,

The FIF regime.)

- All housing wealth held by individual is aggregated and registered first mortgages deducted

- **Net equity** treated as if on term deposit earning say 2-3%

- Housing income is taxed at individual's marginal tax rate

FER would

- *Be Fair*
- *Be simple*

Do away with the need for landlords to feed tax accountants

  - No rental losses
  - No interest write offs
  - Capture capital gain in the equity base over time
  - Divert resources from luxury housing
  - Change the culture of housing as an investment commodity- better use of housing stock

- *Be supported* by tighter current bright line tests for short term gains, LRVs 40%, removal of interest only loans.
- *Be progressive*
  - Affect the top 20% of wealthiest property owners and absentee owners
  - Exemption of up to $1m of net equity per resident, or
  - Exemption apply only to the family home?

Family home exemption?

- Defining a family home problematic?
- Do we need to acknowledge culture of home ownership?
- Is home exemption fair?

Suppose Paul and Wiri have $ 1m each

Paul buys a $1m home to live in

Wiri buys a home for $1m and rents it out for $25,000. And pays $25,000 to live in another place

Is giving a net equity exemption on the family home of $1m to Paul unfair to Wiri?

FER is practical, simple and fair

- Could start 2022/23
- Based on 2021 CVs (government valuation)
- IRD holds a register of housing interests for each taxpayer

  Net equity aggregated as at 1 April 2022

What about houses held in trusts or companies of beneficial interest to the individual?

- Net equity*FER rate = taxable income
- Low FER rate to start– 1%-- rate set as policy tool at range sitting below mortgage rate (2-3.5%).

Example of how FER would work

-

2022/23 Couple own a home CV =$5m
Bach CV =$2m
rental CV =S600,000

Total net equity = $7.6m
each =$3.8 m
after exemption =$2.8m

FER taxable income @ 1% = $28,000

(any Airbnb, boarders, rentals ignored)

After three years CVs are 30% higher

2025/6

- Total net equity= $9.88m
- Each ($1m exemption) net equity $3.88m
- Taxable income of $38,800 if FER rate= 1%
- Or $58,200 if FER rate =1.5%

Incentives to maximise housing use

Net equity grows with capital gains and mortgage repayments

“*To save capitalism, we must help the young. Democratic capitalism is under threat as increasing numbers of young people view the system as rigged against them. The pandemic has only exacerbated their economic disadvantage.*”

Deutsche Bank
Research report
November 2020

International tax developments

December 2020 – UK Wealth Tax Commission proposes one-off wealth tax of 5%

March 2021 – UK Budget proposes increase in corporation tax from 19% to 25% from 2023

April 2021 – President Biden's 'Made in America' tax plan proposes increasing US corporate tax rate from 21% to 28%, increasing the top personal income tax rate to 39.6% and taxing capital gains at top 39.6% rate for those earning more than $1 million

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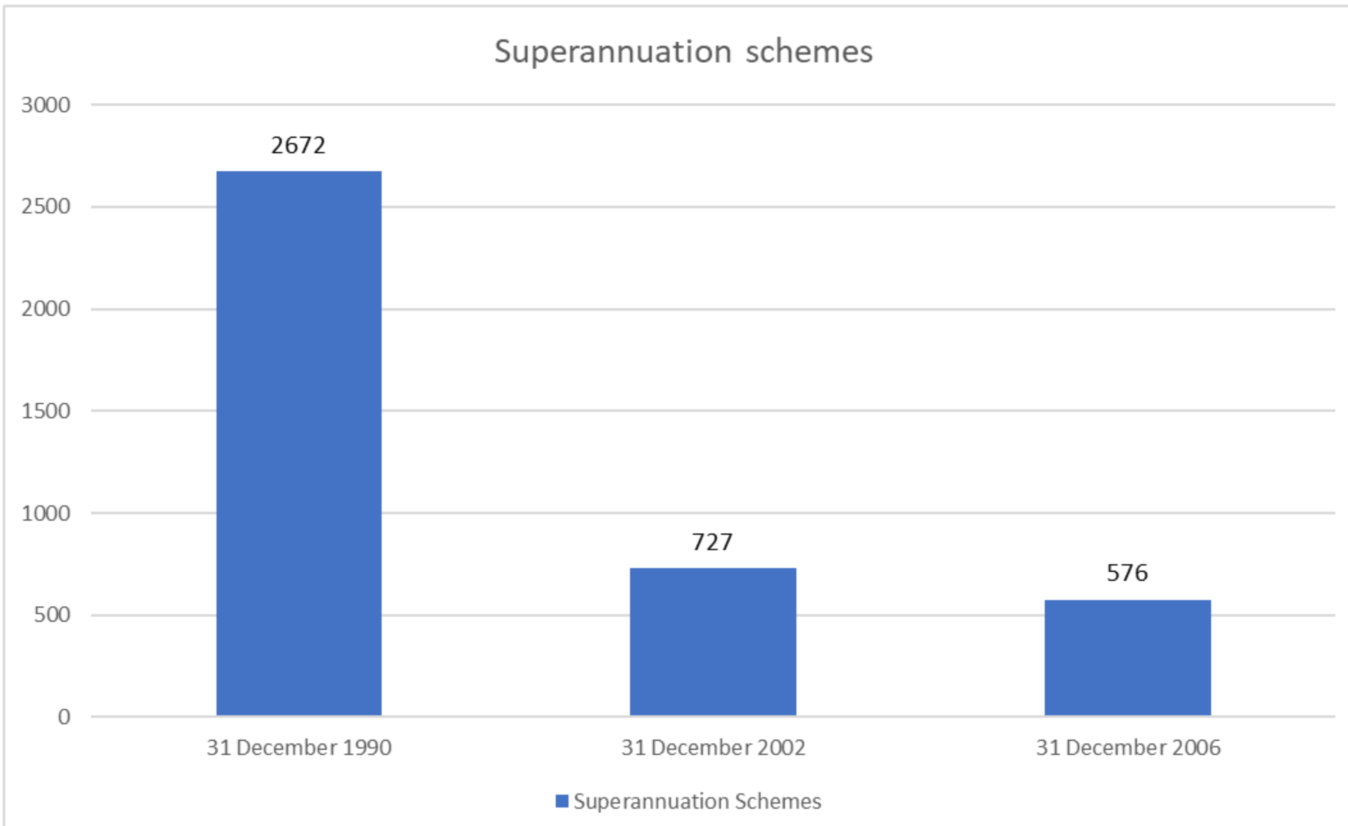
- 1965 UK introduces CGT
- 1972 Canada adopts CGT
- 1985 Australia adopts CGT
- 1986 Financial arrangements regime introduced – an accruals based CGT regime
- 1988 Valabh Committee proposed FIF regime for offshore investments *'should await the introduction of a general capital gains tax'*
- 1989 proposals would have taxed gains on family home
- 2001 South Africa adopts CGT

1988 Superannuation changes – the genesis of the housing crisis?

- 1988 tax exemptions for superannuation schemes ended as part of switch to “tax, tax, exempt” system (complete opposite of previous “exempt, exempt, tax” approach generally preferred worldwide)
- Almost immediately there was a fall in the number of superannuation schemes and the amounts invested
- In September 1993 RBNZ noted this trend which it described as ‘mainly one-off or temporary’

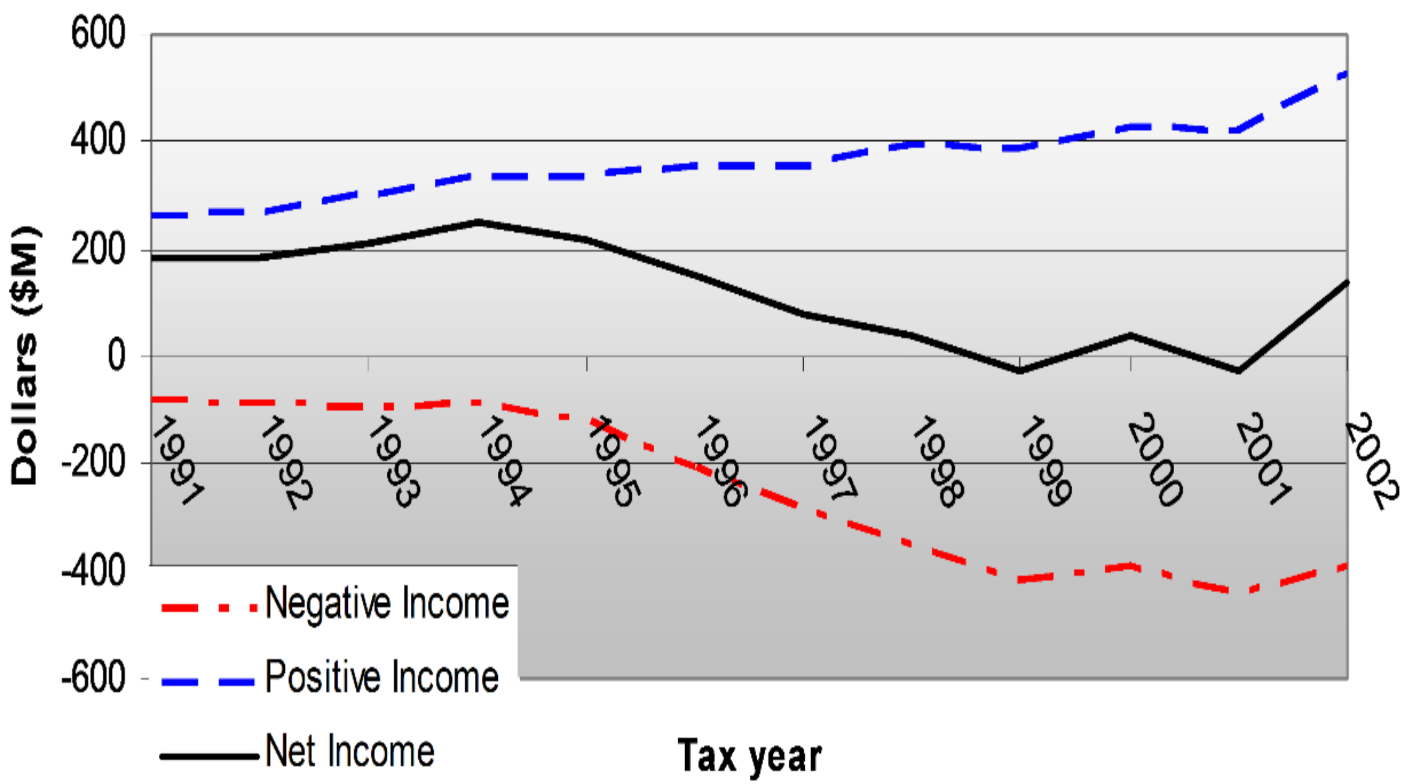
1988 Superannuation changes – the genesis of the housing crisis?



Tilting the playing field…

- In 1991 $10,000 cap on offsetting rental losses against other income removed
- 1992 Loss Attributing Qualifying Company regime introduced
- 1993 depreciation changes
- All of the above changes made investing in property much more attractive
- Between 1991 and 2002 number of individual taxpayers reporting rental income rose by 150%

More investors, less tax?



More investors, less tax?

- Trend begun in 1991 exacerbated by increase in top tax rate to 39% in 2000
- Number of companies (including LAQCs) returning residential property income rose twelvefold between 2000 and 2011 (from 2,400 to 29,800)
- Over five years ended 31st March 2007 to 2011 inclusive companies reported property losses totalling $1.24 billion, nearly $250 million per year

Levelling the playing field…

- Recent property announcements only the latest attempt to restore ‘balance’ for example:
- LAQC regime ended on 31st March 2011 as did depreciation on residential property
- 1st October 2015 Bright-line test introduced for sales within two years
- 28th March 2018 bright-line period extended to five years
- 1st April 2019 loss ring-fencing introduced

What about a Land Tax?

- A low rate applied to value of undeveloped land could raise significant revenue
- Land Tax had been part of tax system but repealed as part of 1980s reforms because too many exemptions minimised the base
- Not considered by 2001 McLeod Review
- 2010 VUW TWG "most members…support the introduction of a low-rate land tax as a means of funding other tax rate reductions"

What about a Land Tax?...But

- Introduction of a land tax would be expected to cause initial fall in value of land
- Interim report of 2019 TWG recommended against land tax for following reasons
- disproportionate impact on groups & industries that hold a greater share of their wealth in land;
- Could apply to heavily geared property owners with negative equity;
- Cash flow impact for those on low incomes;
- Māori submitters argued that Māori would be disproportionately affected by a land tax

Okay what about Stamp Duty?

- Widely used elsewhere in world – notably Australia, Canada and the UK (but NSW moving away from Stamp Duty)
- Application to residential property repealed in 1988 and on commercial property in 1998
- Not considered by any of the 2001, 2010 & 2019 TWGs
- Burden falls on purchaser so unless special exemption applies, problematic for first home buyers. (Deutsche Bank suggested it should be paid by vendors)

A risk-free rate of return regime?

- 2001 McLeod Tax Review mooted risk-free rate of return as “a means of addressing specific problems arising from the current treatment of capital gains.”
- McLeod review suggested applying the Risk-Free Return Method to tax the net equity-component of owner-occupied and rental houses.
- “Unfortunately, no more viable way of making this aspect of the tax system fairer and less distortionary has been identified.”

Foreign investment fund regime

- Following superannuation changes a foreign investment fund(“FIF”) regime was required to ensure New Zealand resident funds not disadvantaged relative to overseas funds
- Initial FIF regime taxed on an accrual basis but as noted above very unpopular & suggestion was that should wait for general capital gains tax
- After tax rate increase in 2000 attraction of low dividend yielding overseas companies grew. Capital gains generally not taxable

FIF regime changes

- McLeod risk-free rate of return method adopted for a new FIF regime with effect from 1 April 2007
- New regime heavily criticised: 3,400 submissions against, only two in support
- *"This legislation will provide an even greater incentive for New Zealanders to bring back their money from overseas and invest in residential property here in New Zealand."*

  Lockwood Smith MP December 2006

FIF regime - basics

Two methodologies to calculate income

Lesser of Fair Dividend Rate (FDR) 5% of the market value at start of tax year

Or

Comparative value (CV) the difference between the market values at the beginning and end of the tax year plus all gains & dividends less acquisitions

FIF regime example

Market value 1 April 2021	$100,000
Closing value 31 March 2022	$103,000
Dividends received in year	$4,000

FDR = 5% x $100,000	=	$5,000 income
CV = $103,000-$100,000 +$4,000	=	$7,000 income

Income reported $5,000 – Note 5% is a MAXIMUM

Dealing with multiple ownerships

How would our proposed Fair Economic Return approach deal with multiple properties owned by combination of trusts, companies and individuals?

By using the existing “associated persons” tax rules

These are used to counter attempts to break adverse implications of being “associated”

Associated persons - example

The associated persons rules deem persons and entities to be associated

They sometimes apply on a daisy-chain basis – if A is associated with B and B is associated with C then A and C are associated

Existing associated persons rules introduced in 2009 and are practically unbreakable

Associated persons - example

John (Settlor)

Trust

100% shareholding

Family home
net equity $1.5m

Rental Property Company

3 rental properties
net equity $2.5m

Associated persons - example

John is settlor of trust and is therefore associated with the trust

The trust is associated with the rental property company as it has a shareholding greater than 25%

Therefore as John is associated with the trust and the trust is associated with the rental property company, the company is associated with John

Associated persons - example

John’s net equity liable for the Fair Economic Return is therefore:

Net equity in family home	$1,500,000
Net equity in company	$2,500,000
Total	$4,000,000
Less annual exemption	-$1,000,000
Total liable for FER	$3,000,000

Conclusions

- Housing market problems systemic & long-standing
- Existing policy options have not worked
- Time for capital gains tax long past
- Fair Economic Return is a circuit breaker
- Taxes accumulated gains which a CGT cannot
- Addresses wealth inequality
- Builds on existing tax rules in FIF regime and associated persons so can be implemented quickly