Government wants to water down de facto Capital gains tax

By **Jenée Tibshraeny**
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Finance Minister Nicola Willis honours National's pre-election promise to reduce the bright-line test to two years from July. Photo / Mark Mitchell

The Government has confirmed its plans to water down the country's de facto capital gains tax, known as the bright-line test.

It's proposing to reduce the test from 10 to two years from July 1.

This means that from July 1, people who sell residential investment property within two years of purchasing it, will have to pay tax on any gains received.

Currently, those who on-sell existing investment property within 10 years, and new builds within five years, are taxed.

After July 1, all property will fall under the two-year test. So, someone who on-sold a property they bought three years ago, wouldn't be taxed under the test, for example.

As is currently the case, someone could be classed an "investor" even if the home they on-sold was the only property they owned.

People are only exempt from the tax if the home is considered their "main home".

Currently, one could be taxed in proportion to the time the property isn't used as a "main home". So someone who moved out of their "main home" to live somewhere else for work for a few years, could be taxed proportionately if they on-sold within the bright-line period.

Under the proposed change, the property would be considered an investment if it wasn't used as the main home for more than half the time it was owned.

The two-year bright-line test would mirror what it looked like when it was first introduced by the former National-led Government.

Revenue Minister Simon Watts said, in an amendment paper to the bill that makes the proposed change, that the aim is to return the bright-line test to its “original purpose of ensuring land speculators pay their fair share of tax on gains from property sales”.

The Taxation (Annual Rates for 2023–24, Multinational Tax, and Remedial Matters) Bill will be passed before the tax year ends on March 31.

Deloitte tax partner Robyn Walker said returning the bright-line test to two years would remove a lot of the complexity that accompanied the expansion of the test.

The Labour-led Government had extended it to five, and then 10 years when the property market over-heated on the back of all the Covid stimulus in 2021.

Walker said the change might prompt those who bought investment property in recent years, and were keen to sell, to hold off until after July 1.

The Reserve Bank, in its latest Monetary Policy Statement, similarly noted there could be a flurry of listings after July 1, as investors who have owned their properties for longer than two years, but less than five or 10 years, opt to sell.

This could, according to the bank, dampen house prices in the short-term.

A large number of listings is already suppressing house price growth.

Looking further down the track, the Reserve Bank believed reducing the tax would make property “marginally” more attractive to investors and therefore put a little bit of upward pressure on prices.

The proposed change to the bright-line test aligns with what National campaigned on ahead of the election. Act would prefer to the have the test abolished altogether.

Before the election, National expected the change would save investors about $50 million a year.

Contrary to what the Government has been arguing, the Reserve Bank believed changing the bright-line test and restoring the ability of investors to write off mortgage interest as expense when paying tax, would primarily affect house prices rather than rents.

In other words, landlords are unlikely to pass tax savings on to renters.

“Recently published research has found the drivers of rents in New Zealand in the past 20 years have been the number of people per dwelling and nominal income,” the Reserve Bank said.

“We therefore expect that changes in tax and interest rates are primarily capitalised into land prices.”

The interest limitation rule means that residential property investors, who bought from March 27, 2021, cannot deduct any mortgage interest as an expense when paying tax on their rental

income. Meanwhile those who bought before then, can deduct 50 per cent of their interest in the current tax year.

Under the proposed policy change, all investors will be able to deduct 80 per cent of their interest in the next tax year, which starts on April 1. Then from April 1, 2025, they'll be able to deduct all their interest.

The change will be particularly helpful for investors with a large mortgages, struggling with cashflow.

Nonetheless, it could make it harder for owner-occupiers to compete with investors, as they cannot offset their mortgage interest against their incomes to pay less tax.

The Reserve Bank believed phasing out the interest limitation rule would put a small amount of upward pressure on house prices.

It noted that high interest rates still mean buyers need to able to prove to their banks they can service debt at elevated rates.

The Reserve Bank also made the point new builds are exempt from the interest limitation rule.

Furthermore, the rule only affects investors with mortgages. Those without debt, and owner-occupiers (who account for about 63 per cent of sales) aren't affected.