

Design of the interest limitation rule and additional bright-line rules

A Government discussion document

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Minister of Revenue



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Chapter 1

Overview of proposals and process

Objective of this consultation

- 1.1 In March 2021 the Government announced its intention to limit the deductibility of interest on residential investment property. This consultation document seeks public feedback on design matters for implementing this proposal. The objective is to introduce the changes as fairly and simply as possible, and public feedback will help achieve that. This document also seeks views on some aspects of the bright-line test for taxing residential property sales. The Government has made clear that none of the proposed changes apply to the family or main home.
- 1.2 In introducing these changes, the Government's housing objectives are to:
 - ensure that every New Zealander has a safe, warm, dry, and affordable home to call their own – whether they are renters or owners
 - support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers, and
 - create a housing and urban land market that credibly responds to population growth and changing housing preferences, that is competitive and affordable for renters and homeowners, and is well-planned and well-regulated.
- 1.3 New Zealand has a long-standing housing affordability problem. To address the role of tax in this problem, the Government introduced changes to the taxation of residential property in 2018 and 2019 to make residential property investment less tax advantageous. These measures included lengthening the period of the bright-line test and introducing rules to ring-fence losses on residential investment property. The Government now believes further changes are desirable.
- 1.4 While the Government is aware that tax is neither the sole cause nor the sole solution to the housing issue, it does contribute to investor demand. This consultation round therefore aims to gather views on design considerations for implementing the announced tax policy proposals in interest limitation.

Things to bear in mind

- 1.5 In developing these rules, the Government must balance several housing, economic and tax policy objectives. Submitters should also consider these in considering the proposals.
 - *Housing affordability* The Government wishes to reduce the incentive for non-owner-occupiers to invest in existing residential properties. This will reduce the upward pressure on housing prices. The goal is to make

the purchase of residential properties more affordable for potential owner-occupiers.

- *Housing supply* The interest limitation and bright-line extension should not discourage new additions to the stock of housing.
- *Efficiency* The interest limitation measure should not have unintended effects on the efficient allocation of investment. For instance, the measure should not increase after-tax financing costs for other business activities.
- *Coherence of tax system* The rules should reduce opportunities for changes in the timing or form of arrangements and transactions, to alter tax results in ways that could frustrate achieving the housing objectives
- *Complexity of the tax system* The rules should not be unduly complex, so that they raise unnecessary administrative and compliance costs.

1.6 Inevitably it will be necessary to make trade-offs between these objectives. We welcome submissions on the proposed design of the rules for interest limitation and the additional bright-line rules.

The proposals

1.7 The housing market is complex with a wide spectrum of owners, with differing levels of complexity, and this discussion document aims to cover the proposals as they relate to all residential property investors. This document has therefore been drafted so that for most owners, it is not necessary to read the entire document, but to go to the chapters relevant to different investors. Individual chapters contain specific questions for submitters to consider. Here is a brief overview of what is covered. The matters described below are explored in more detail in the chapters named.

High level outline

1.8 Deductibility of interest expenses incurred by residential property investors will be restricted from 1 October 2021. The amount of the restriction will depend on whether the interest is “grandparented” or not.

1.9 Grandparented interest is interest on debt drawn down before 27 March 2021 relating to residential investment property acquired before 27 March 2021. For grandparented interest, deductions will be gradually phased out between 1 October 2021 and 31 March 2025 as follows:

Date interest incurred	Percent of interest you can claim
1 April 2020–31 March 2021	100%
1 April 2021–31 March 2022 (transitional year)	1 April 2021 to 30 September 2021 – 100% 1 October 2021 to 31 March 2022 – 75%
1 April 2022–31 March 2023	75%
1 April 2023–31 March 2024	50%
1 April 2024–31 March 2025	25%
From 1 April 2025 onwards	0%

- 1.10 Non-grandparented interest is interest on debt funding the purchase of a property acquired on or after 27 March 2021, and drawdowns of debt which relate to the ownership or use of residential investment property on or after 27 March 2021. For non-grandparented interest, all deductions will be disallowed from 1 October 2021.
- 1.11 There will be favourable treatment for property being developed and owners of new build properties (see chapters 6-9).

Who will be subject to the rules

Chapter 2 - Residential investment property subject to interest limitation

- 1.12 This chapter aims to establish a shared understanding of the scope of the proposals and the terms used. It sets out the policy objectives of the proposals. This chapter covers the types of residential property subject to the proposed interest limitation rules and outlines issues the Government has identified in defining the types of affected property. It also suggests exclusions from the interest limitation proposal for specific property types.
- 1.13 In general, the proposals will apply to interest on debt used to purchase or operate residential investment property, which is primarily residential property rented to tenants.
- 1.14 Among the residential property that are proposed to be excluded are:
- Land outside New Zealand
 - Employee accommodation
 - Farmland
 - Care facilities such as hospitals, convalescent homes, nursing homes, and hospices
 - Commercial accommodation such as hotels, motels, and boarding houses
 - Retirement villages and rest homes; and
 - Main home - the interest limitation proposal would not apply to interest related to any income-earning use of an owner-occupier's main home such as a flatting situation.
- 1.15 The Government is interested in feedback on these issues in order to better understand the complexities faced in these areas.
- 1.16 Possible exclusions for certain student accommodation, serviced apartments, and Māori land are also considered.

Chapter 3 - Entities affected by interest limitation

- 1.17 The proposals will affect entities like companies differently from individuals. Companies are generally allowed deductions for interest without needing to

trace the use of their borrowed funds. The interest limitation rules will override this general rule for close companies and companies whose assets are primarily (more than 50%) residential investment property so that taxpayers cannot circumvent the interest limitation proposal by using companies to borrow to acquire residential investment property.

- 1.18 The Government proposes to exempt Kāinga Ora and its wholly-owned subsidiaries from the interest limitation rules. If there are other organisations that submitters consider should not be subject to the interest limitation proposal, we invite submitters to provide a description of those organisations' activities and explain why they consider an exclusion is appropriate.

Interest that would be affected

Chapter 4 - Interest subject to limitation

- 1.19 Where a loan is used for a mixture of taxable and non-taxable purposes it is already necessary to trace the funding to each purpose to determine deductibility (unless the borrower is a company). This chapter proposes the same approach for loans used to fund residential investment property. It also covers refinancing an existing loan and transitional issues relating to pre-27 March debt. The aim is to have fair and consistent results, taking into account the Government's overall objectives, and to minimise administrative and compliance costs.

Chapter 5 - Disposals of property subject to interest limitation

- 1.20 This chapter considers whether interest deductions should be allowed in some cases when a property is sold. Specifically, the chapter considers whether a property owner can get a deduction for interest when they sell the property (for example when the property is subject to tax on sale due to the bright-line test). It also considers the interaction of any deduction with the bright-line test and rental loss ring-fencing rule.

Exemptions

Chapter 6 - Property development and related activities

- 1.21 The Government has decided that property developers should be exempt from the proposed interest limitation rules. This supports the policy objective of increasing housing supply through the construction of new builds. This chapter considers the definition of "development" and the scope of the development exemption. It also considers options for applying the exemption to one-off developments as well as to professional developers. It discusses whether some remediation work may qualify for the development exemption where it adds to the housing stock, for example by extending the life of older buildings or making a building habitable.

Chapter 7 - Definition of "new build"

- 1.22 The Government has decided that "new-build" residential properties should be exempted from the proposed new interest limitation rules and subject to a

five-year bright-line test (rather than a ten-year test). Chapter 7 suggests property could be considered a “new build” when:

- a dwelling is added to vacant land
- an additional dwelling is added to a property, whether stand-alone or attached
- a dwelling (or multiple dwellings) replaces an existing dwelling
- renovating an existing dwelling to create two or more dwellings.
- a dwelling converted from commercial premises such as an office block converted into apartments.

Chapter 8 - New build – exemption from interest limitation

- 1.23 This chapter sets out the proposed design of the new build exemption from the interest limitation rules (the new build exemption), including for how long the exemption should apply to early owners. It proposes that early owners (those who acquire a new build no later than 12 months after its Code Compliance Certificate (CCC) is issued, or add a new build to their land) would be eligible for the new build exemption. This chapter also asks whether subsequent purchasers (those who acquire a new build more than 12 months after the new build’s CCC is issued and within a fixed period such as 10 or 20 years from the date that CCC is issued) should qualify for the exemption.

Chapter 9 - Five-year bright-line test for new builds

- 1.24 Owners of new builds would be subject to a five-year bright-line period rather than the extended ten-year period. This chapter discusses what the new build bright-line test is and who it applies to.

Chapter 10 - Rollovers – bright-line test and interest limitation

- 1.25 This chapter proposes some limited relief from the interest limitation rule and bright-line test in relation to transfers to trusts and transfers where there is no significant change in ownership. This relief involves deferring the taxing point until there is a future disposal of the property that does not qualify for rollover relief. This chapter proposes some limited rollovers to deal with transfers to trusts and transfers where there is no significant change in ownership. It is relevant for both the interest limitation rule and bright-line test.

Technical issues

Chapter 11 - Interposed entities

- 1.26 Under current law, taxpayers are normally allowed to deduct interest on loans used to acquire shares in a company. This chapter proposes interposed entity rules to ensure that taxpayers cannot claim interest deductions for borrowings used to acquire residential investment property indirectly, through an interposed entity.

Chapter 12 - Implications for rental loss ring-fencing rules

- 1.27 Ring-fencing rules restrict rental loss expenses that can be claimed against residential property income. This restricts the tax benefits of residential property investments. The interest limitation rules will further reduce these benefits. There is likely to be significant interplay between the proposed interest limitation rules and the existing ring-fencing rules.
- 1.28 This chapter discusses the overlap between the ring-fencing rules and the proposed interest limitation rules and the technical issues that are likely to arise.

Chapter 13 - Effect on property subject to tax under the mixed-use asset rules

- 1.29 The focus of the interest limitation rules is on debt relating to residential investment property, but they will also apply to baches and other second homes if used to earn income. This chapter considers how the proposal will be coordinated with the existing MUA rules.

Chapter 14 - Compliance and administration

- 1.30 This chapter considers the administrative aspects of the interest limitation rule and bright-line extension. It outlines the proposed approach to administering these changes in terms of making the rules work, ensuring compliance, and informing Government about appropriate targeting and effectiveness.

How to make a submission

- 1.31 Submissions are invited on the options and proposals in this discussion document.
- 1.32 Your submission should include a brief summary of your main points and recommendations. Please also indicate whether officials from Inland Revenue may contact you to discuss the points raised, if required.
- 1.33 The closing date for submissions is **12th July 2021**.
- 1.34 Submissions can be made:

by email to policy.webmaster@ird.govt.nz with
“Design of the interest limitation rule and additional bright-line rules” in the subject line; or

by post to:
Design of the interest limitation rule and additional bright-line tests
C/- Deputy Commissioner, Policy and Regulatory Stewardship
Inland Revenue Department
P O Box 2198
Wellington 6140

- 1.35 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their publication. The withholding of responses on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If you consider that any part of your submission should properly be withheld under the Act please clearly indicate this.

Chapter 2

Residential property subject to interest limitation

Introduction

- 2.1 This chapter covers the types of residential property that would be subject to the proposed interest limitation rule. It first outlines how the Government's stated objectives can be used to provide a broad roadmap to inform the scope of property. The chapter then discusses the appropriateness of existing definitions in the Income Tax Act 2007 (the ITA). It also outlines various issues the Government has identified in defining the scope of affected property and seeks feedback on these.
- 2.2 An exemption from the interest limitation rule is proposed for interest on loans relating to new builds. What constitutes a new build is covered in chapter 7.

Policy objectives and broad scope

- 2.3 As a starting point, the Government's intention is for the proposals to cover property that is commonly and foreseeably used to provide residential accommodation on a long-term basis.
- 2.4 In line with the Government's objective to tilt the playing field away from property investors and towards first home buyers, the scope of the proposed new rules can be further refined to types of property that could be used as a private owner-occupied residence.
- 2.5 The Government considers that the proposed rules should be restricted to property located in New Zealand on the basis that investments in properties outside New Zealand have no direct impact on New Zealand housing.
- 2.6 In-scope residential property would include property in use as long-term residential accommodation (such as residential rental property covered by the Residential Tenancies Act 1986) or property that is easily substitutable for long-term residential accommodation (such as homes converted into short-stay accommodation – commonly advertised on digital platforms). At the simplest level, it should include a house or apartment, regardless of whether it is used to provide long-term or short-stay accommodation. Income tax should not play a role in determining whether a given property is used to provide long-term rental accommodation or short-stay accommodation.
- 2.7 Given the scope outlined above, commercial properties that are not set up to provide accommodation (for example, office buildings and shops) are not intended to be covered by the proposed interest limitation rule.
- 2.8 However, there are commercial properties that are used to provide accommodation. Commercial accommodation can take a variety of forms, and each category should be considered on a case-by-case basis.

- 2.9 In some cases, the provision of accommodation is related but ancillary to another function of the property (for example, a hospital or hospice). The Government considers that in most cases, these types of properties should not be impacted. This is because while stays in such properties could be long-term, they are generally not substitutable for an owner-occupied property.
- 2.10 In other cases, the provision of accommodation is the core function of the property or business. Properties used to provide accommodation on a commercial basis can take a variety of forms, of which some cannot easily be made suitable for owner-occupation (for example, a hotel or motel) and some could more easily be used or converted this purpose (for example, short-stay accommodation in what could otherwise be a regular residential home).
- 2.11 In determining whether a property in this category should be within scope of the interest limitation rule, the Government's key consideration is whether the property is of a type that would normally be available for owner-occupiers. If a property is not of a type that is generally available for owner-occupation or easily convertible to owner-occupation, there is a greater argument for exclusion.
- 2.12 The Government has identified the following relevant factors as a guideline to help determine whether a property type is generally suitable for owner-occupation:
- *Regulatory framework and population:* is the property subject to a specific regulatory framework? Are there well-defined rules about who can reside in the accommodation and is this limited to a certain sector of the population? Are wraparound services mandated? For example, section 5 of the Residential Tenancies Act 1986 provides that the Act does not apply to specific types of student accommodation or retirement village accommodation.
 - *Physical structure and configuration:* are the accommodation units configured in such a way that they could be occupied by a private owner-occupier as a stand-alone dwelling unit?
 - *Unconditional occupation:* can a person occupy the residence indefinitely, or is their occupation conditional on factors other than a tenancy (for example, holding a particular position such as employment)?
 - *Incentive for, and barriers to, conversion:* would exclusion of a particular category incentivise and enable the conversion of existing residential property into this type of accommodation? What are the barriers to this conversion process? For example, is the existence of a regulatory framework, as described above, a significant barrier to conversion? Where there are multiple accommodation units on a single title, could they be converted with relative ease to separate titles?
- 2.13 It is anticipated that most property types carved out will meet some of these factors but not others. In developing a final set of criteria, the Government's decision making will be informed by a balance of these factors, rather than whether a type of property meets or does not meet any given factor.

Proposed approach

- 2.14 Given the scope outlined above, the Government considers that existing definitions used in the ITA provide a reasonable basis for developing the scope of the proposed rules – in particular, definitions used for the purposes of the bright-line test and the residential ring-fencing rules. Broadly, these definitions cover land which is, is planned to be, or could be used for residential accommodation.
- 2.15 There are a number of areas where the Government is considering modifications or departures from existing definitions to support the intent of the interest limitation rules. These areas are discussed in the next section: **Issues for further discussion.**
- 2.16 This section sets out the relevant existing definitions and describes their features. It also covers aspects of existing definitions that would align with the Government’s stated intent, and changes that may be appropriate.

Key definitions in the Income Tax Act 2007

- 2.17 The key definitions for the bright-line test are the definitions of “residential land” and “dwelling” in section YA 1 of the ITA.¹ Related definitions include the definitions of “farmland”, “business premises”, and “main home” in section YA 1. The definitions of “residential land” and “dwelling” were updated by the Taxation (Annual Rates for 2021–22, Feasibility Expenditure, and Remedial Matters) Act 2021.
- 2.18 These definitions are provided in this section for reference and discussion:

Residential land

- (a) means—
- (i) land that has a dwelling on it, unless the land is farmland, or is used predominantly as business premises;
 - (ii) land for which the owner has an arrangement that relates to erecting a dwelling, unless the land is farmland or is used predominantly as business premises;
 - (iii) bare land that may be used for erecting a dwelling under rules in the relevant operative district plan, unless the bare land is farmland or is used predominantly as business premises; and
- (b) includes land that has a dwelling on it, if it is used by a person predominantly as business premises for a business of supplying accommodation and the dwelling is not a main home for the person or 1 or more other persons referred to in section CB 16A(2) (Main home exclusion for disposal within 10 years).

¹ Note that definition of “dwelling” used for income tax purposes differs to that used for GST purposes as the two regimes apply for different purposes.

Dwelling

- (a) means any place configured as a residence or abode, whether or not it is used as a place of residence or abode, including any appurtenances belonging to or enjoyed with the place:
- (ab) despite paragraph (a), for the purposes of subpart EE and the definitions of commercial building, commercial fit-out, and residential building, means any place used predominantly as a place of residence or abode, including any appurtenances belonging to or enjoyed with the place:
- (b) does not include any of the following, in whole or part:
 - (i) a hospital:
 - (ii) a hotel, motel, inn, hostel, or boardinghouse:
 - (iii) a serviced apartment for which paid services in addition to the supply of accommodation are provided to a resident, and in relation to which a resident does not have quiet enjoyment, as that term is used in section 38 of the Residential Tenancies Act 1986:
 - (iv) a convalescent home, nursing home, or hospice:
 - (v) a rest home or retirement village, except to the extent that, in relation to a relevant place, it is, or can reasonably be foreseen to be, occupied as a person's principal place of residence for independent living:
 - (vi) a camping ground:
- (c) despite paragraph (b)(iii) and (v), for the purposes of section CB 16A (Main home exclusion for disposal within 5 years) and the definition of residential land—
 - (i) includes a serviced apartment described in paragraph (b)(iii):
 - (ii) does not include, in whole or part, a rest home or retirement village

Business premises

- (a) means the normal business premises or a temporary workplace of the person (or an associate):
- (b) does not include premises or a workplace established mainly for the purpose of enjoying entertainment

Farmland means land that—

- (a) is being worked in the farming or agricultural business of the land's owner:
- (b) because of its area and nature, is capable of being worked as a farming or agricultural business

Main home means, for a person, the 1 dwelling—

- (a) that is used as a residence by the person (a home); and
- (b) with which the person has the greatest connection, if they have more than one home

Land in New Zealand

- 2.19 While the bright-line test applies to worldwide property, the Government proposes to restrict the application of the interest limitation rules to properties located in New Zealand. It proposes to exclude foreign properties on the basis that New Zealanders investing in properties outside New Zealand do not have a direct impact on the New Zealand housing market.

Residential land

- 2.20 “Residential land” is land which has a dwelling on it, on which a dwelling is being or intended to be erected, or which is bare land that could be used for erecting a dwelling. This is captured by the definition in paragraph (a). This seems appropriate for the interest limitation rule.
- 2.21 Note that the definition of “residential land” hinges on the definition of “dwelling”, which is discussed from paragraph 2.34 onwards.
- 2.22 The definition of “residential land” means that a piece of land can be residential land if there is a dwelling on the land, even if there are other buildings on the land that are not dwellings. However, there are carveouts for farmland and business premises.

Farmland

- 2.23 Farmland is carved out of the definition of “residential land”. “Farmland” is defined as land that is being worked in the farming or agricultural business of the land’s owner, or which is capable of being worked as a farming or agricultural business. Farmland with a dwelling on it is still farmland and therefore excluded, even where the dwelling is used to provide accommodation – either to employees or a third party.
- 2.24 The Government does not intend that the interest limitation rules would impact interest deductions that are taken in relation to a farming business for the provision of employee accommodation. The Government therefore considers that it would be appropriate to for farmland to be similarly carved out from the scope of the interest limitation proposal. The Government seeks submissions on whether the existing definition of “farmland” is appropriate for the interest limitation rules.
- 2.25 There are potential issues where the employee accommodation is on a separate piece of land to the farmland. This issue is discussed in the section titled Issues for further discussion.

Business premises

- 2.26 The definition of “residential land” also excludes a piece of land that is predominantly used as business premises.² This is important as otherwise the existence of a dwelling on a piece of land would characterise the whole piece

² Note that while providing long-term rental accommodation can potentially constitute a business, the rental properties are unlikely constitute business premises.

of land as residential land, even where there are also commercial premises on the land.

- 2.27 Dual-purpose buildings are found in many towns and cities around New Zealand, for example, a building where there is a shop on the ground floor and one or more floors containing apartments above. Sometimes the different parts of these buildings might be on separate titles, or they could be on one single title.
- 2.28 The business premises exclusion is relevant where the dual-purpose building is on a single title. It is also relevant where a residential property has been converted to business premises but still meets the definition of a “dwelling”. It is not relevant where the commercial (non-accommodation) part of a building is on one title and the residential accommodation part is on a separate title.
- 2.29 The business premises exclusion operates on all-or-nothing basis by looking at the different uses of the property on a time and space basis (for example, floor area). The requirement of predominant use is effectively a “more than 50%” test. Residential land with greater than 50% of area used as business premises is carved out, while a building with 50% or less area used as business premises is residential land. This approach minimises compliance costs by providing a simple test for dual-purpose buildings.
- 2.30 If this carveout is adopted in the context of the interest limitation rule, there may be concerns about interest deductions being denied in respect of an office or shop space on the same title as residential accommodation. For example, if the office or shop accounted for 25% of the land, no interest deductions would be available at all.
- 2.31 The Government considers that a business premises exclusion would be appropriate for the proposed interest limitation rule, particularly given the prevalence of dual-purpose buildings around New Zealand. However, the all-or-nothing approach used for the bright-line test may not be appropriate for interest limitation and these concerns are considered in the next section titled Issues for further discussion.
- 2.32 Paragraph (b) of the definition of residential land disqualifies a dwelling used to provide certain types of short-stay accommodation from the business premises exclusion. Where short-stay accommodation is provided in a dwelling that is business premises, the exclusion from “residential land” is only available where the residential land is also the owner’s main home (for example, a traditional bed and breakfast where the owner lives on site).
- 2.33 Similar treatment is proposed for the interest limitation rules. The underlying policy rationale is equally applicable in the context of the interest limitation rules – the Government considers it important that where a residential property could be used to provide long-term rental accommodation, the income tax treatment is the same whether the property is used to provide long-term rental accommodation or short-stay accommodation. Any income tax advantage provided for properties used for short-stay accommodation could reduce effective housing supply.

Dwelling

- 2.34 A “dwelling”, for the purposes of the bright-line test, is defined in paragraph (a) as a place configured as a residence or abode, whether or not it is used as such, and includes any appurtenances (that is, assets that are attached to and used as part of the dwelling).
- 2.35 The carveouts in paragraph (b) are broadly intended to cover housing units that serve purposes other than long-term residential accommodation – including commercial short-term housing such as hotels and motels, care facilities such as hospitals and nursing homes, and retirement villages. Since the bulk of property being carved out is not substitutable for private owner occupation and any long-term accommodation in the facility is incidental, or ancillary to the provision of other services, the Government considers that most of these carveouts could readily be imported into the interest limitation regime.
- 2.36 Under the previous formulation in paragraph (a) of the definition of “dwelling”, which focused on use as a residence or abode, these carveouts put beyond doubt that these facilities are not included, even though in some situations, they could be used by a person for longer-term accommodation; for example, emergency housing can be provided by hotels and motels. Under the current formulation of (a), many of these facilities would not meet the requirement of configuration as a place of residence or abode in any event, but again, the carveouts in (b) provide certainty.

Configuration as a residence or abode

- 2.37 The reference to configuration in paragraph (a) ensures that unoccupied residential properties (vacant or so-called “ghost” houses) and typical residential properties used solely to provide short-stay accommodation are captured. The amended definition removes any potential ambiguity in relation to baches and holiday homes that are rented out occasionally.
- 2.38 The Government considers it appropriate that these kinds of dwellings are within the interest limitation rules. The rationale in paragraphs 2.32 and 2.33 applies here too.

Care facilities

- 2.39 Subparagraphs (b)(i) and (iv) carve out accommodation in the context of medical care: hospitals, convalescent homes, nursing homes, and hospices. These forms of accommodation are specifically intended for patients and those in need of care, and are easy to distinguish from housing typically available as a private residence for owner-occupiers.
- 2.40 The Government considers that the carveouts for these forms of accommodation are appropriate in the context of interest limitation.

Commercial accommodation

- 2.41 Subparagraphs (b)(ii) and (vi) in the definition of dwelling carve out specific types of commercial accommodation (that is, hotels, motels, inns, hostels, boardinghouses, and camping grounds) from the definition of a dwelling.
- 2.42 These forms of accommodation are designed predominantly for short-term use on a commercial basis, often at scale. They are straight-forward to distinguish from properties that could be a private owner-occupied residence.
- 2.43 The Government does not intend that such properties are within scope. While there may be instances where commercial short-term accommodation providers are used to provide long-term accommodation (for example, a motel used to provide emergency housing), this is not their main function and they do not generally compete with long-term residential housing.

Serviced apartments

- 2.44 Serviced apartments provide long-term or short-term accommodation, with amenities provided for use. These apartments are carved out of the definition of “dwelling” by subparagraph (b)(iii) for the purposes of certain tax rules relating to commercial buildings (for example, the commercial fit-out depreciation rules). However, such apartments are brought back into the “definition” of dwelling specifically for the purposes of the bright-line test (subparagraph (c)(i)).
- 2.45 These units have physical characteristics shared by both hotel rooms and residential apartments, and can resemble either. Unlike hotels, it is not straight-forward to distinguish them from properties typically suitable for owner-occupation. This issue is discussed in more detail in the next section Issues for further discussion.

Retirement villages and rest homes

- 2.46 Subparagraph (c)(ii) carves out retirement villages and rest homes from the definition of “dwelling” for the purposes of the bright-line test. Retirement villages are defined in the Retirement Villages Act 2003 as premises containing 2 or more residential units that provide, or are intended to provide, residential accommodation together with services or facilities, or both, predominantly for persons in their retirement. The Health and Disability Services (Safety) Act 2001 considers rest home care to be services provided on premises principally held out as “a residence for people who are frail because of their age”. Both retirement villages and rest homes are subject to regulatory frameworks set out in the above Acts.
- 2.47 The Government proposes to exclude retirement villages and rest homes from the proposed interest limitation rules.

Income derived from a main home

- 2.48 Generally, an owner-occupier of a residential property cannot claim a deduction for interest on loans relating to that property, since there is no nexus

(or connection) between the interest expense and the homeowner's income earning process or due to the inability to deduct private expenditure.

- 2.49 However, an owner-occupied dwelling can be used to derive income while also being the owner's home. For example, a homeowner may receive income from renting out part of their home to a flatmate, a private boarder, or a short-stay guest.
- 2.50 All of these types of rental income are taxable, but the person can deduct their actual costs related to earning this rental income to reduce the income tax they need to pay. This includes a portion of the interest on their home loan, using existing rules on apportionment. This is called the actual-cost method.
- 2.51 Slightly different rules apply where someone has private boarders or provides short-stay accommodation to a paying guest in their main home.³ As an alternative to the actual-cost method outlined above, there are simplified rules that may be available, known as the standard-cost method. If this method is used, standard costs are determined by the Commissioner of Inland Revenue, reflecting the likely average costs incurred by hosts of private boarders or those providing short-stay accommodation in their home. Income below the set standard cost does not need to be included in a person's income tax return. Some standard costs factor in a portion of home loan interest.
- 2.52 The Government considers that it would be appropriate to continue to permit interest deductions to be taken where a homeowner rents out a room (or rooms) in their main home to flatmates, private boarders, or as short-stay accommodation. These arrangements fall outside of the scope of the Government's objectives for the proposed interest limitation rules. Some first-home buyers may rent out a room in their main home to help with servicing their mortgage. Denying interest in these situations would not further the policy objective of making home ownership more affordable. Allowing interest deductions in these situations may assist in mitigating under-utilisation of owner-occupied property, as it would not discourage homeowners from taking on flatmates.
- 2.53 This means the current rules on allowable interest deductions would continue to apply in these situations. When using the actual-cost method, the homeowner would continue to be able to deduct the appropriate portion of mortgage interest. Similarly, if the homeowner uses the standard-cost method, the homeowner's "standard costs" would continue to factor in financing costs.
- 2.54 However, the proposed interest limitation rules would apply where a property owner rents out a separate dwelling that is not part of their home but is on the same land as their main home (for example, a self-contained flat or a cottage).
- 2.55 This proposal would rely on the existing definition of main home as replicated above.

³ Private boarders are different to flatmates. When private boarders rent rooms in a house, part of the rent they pay is for services. These are services like regular meals or laundry. A common example of a private boarder is a home-stay student staying with a host family in their home.

2.56 A further issue relates to where there is a change of use from the owner's main home during the phase-out period for properties acquired before 27 March 2021. This is discussed in the next section: Issues for further discussion.

Issues for further discussion

2.57 This section discusses potential limitations of using the bright-line test definitions in the context of the proposed interest limitation rules. Some of these issues have been raised elsewhere in this chapter.

2.58 There are places where the objectives of the bright-line test and the proposed interest limitation rules differ, so the Government is considering whether the carveouts in the interest limitation rules should align fully or differ in certain respects from those used for the bright-line test.

2.59 The main areas identified in this section are:

- Change of use from a main home during the phase-out period (*paragraphs 2.61 to 2.63*)
- The business premises exclusion, particularly in relation to dual-purpose buildings on a single title (*paragraphs 2.64 to 2.69*)
- Employee accommodation (*paragraphs 2.70 to 2.74*)
- Student accommodation (*paragraphs 2.75 to 2.79*)
- Short-stay accommodation in a place that is not typically suitable for owner occupation (*paragraphs 2.80 to 2.82*)
- Serviced apartments (*paragraphs 2.83 to 2.86*)
- Māori land, particularly in the context of papakāinga housing (*paragraphs 2.87 to 2.96*).

2.60 The Government is interested in feedback on these issues and better understanding the issues and complexities faced in these areas.

Change of use from main home during the phase-out period for properties acquired before 27 March 2021

2.61 It is proposed that interest deductions in respect of residential property acquired on or after 27 March 2021 would not be allowed from 1 October 2021. Interest on loans for property acquired before 27 March 2021 would still be able to be claimed as a deductible expense, but would be phased out over four income years. Further discussion on the proposed phase-out can be found in chapter 1.

2.62 Whether interest deductions are fully denied from 1 October 2021 or are phased out hinges on when the property was acquired, not its use as at 27 March 2021. As such, the phase-out will apply where a property was acquired before 27 March 2021, is used as the owner's main home on or after 27 March 2021, and the property subsequently becomes a rental property (for

either long-term or short-stay accommodation) during the phase-out period. The Government considers that this is appropriate.

- 2.63 Where a property is converted to business premises (excluding for the provision of short-stay accommodation), interest deductibility on an ongoing basis beyond the phase-out period would be provided in one of two ways. If it is still configured as a dwelling, the business premises exclusion would apply (presuming predominant use as business premises). If the conversion process is extensive and, as such, the property is no longer configured as a residence or abode, it would fall outside the scope of the interest limitation rules altogether.

Example 1: Change of use during phase-out period

Katie acquired her main home in 2017 and lives in it until she permanently moves to a different city for a new job at the end of September 2022. She rents out her property from 1 October 2022.

Katie is charged \$1,250 interest each month on her mortgage, or \$7,500 every 6 months. Katie has a standard balance date, ending 31 March.

Katie cannot claim any interest for the 2021–22 income year as it was her main home for the full year.

For the 2022–23 income year Katie claims a deduction of \$5,625 interest (being 75% of \$7,500 for the 6-month period of 1 October 2022 to 31 March 2023). For the 2023–24 income year she claims \$7,500 interest charged as an expense (50% of \$15,000). In the 2024–25 income year she claims \$3,750 (25% of \$15,000). From the 2025–26 income year onwards Katie is no longer able to claim any interest against her rental income.

Business premises and dual-purpose buildings on the same title

- 2.64 As mentioned in paragraph 2.26, the existing definition of “residential land” excludes land that is predominantly used as business premises. As such, where there are multiple buildings or dual-purpose buildings on the same title there will be a question about what the land is predominantly used for.
- 2.65 This business premises carveout from “residential land” for the bright-line test operates on an all-or-nothing basis based on predominant use (effectively a “more than 50%” test). This test is intended to minimise compliance costs for dual-purpose buildings where the different parts are on a single legal title. If the business premises are more than 50% of the total residential land, it is fully excluded; if not, it is fully included.
- 2.66 In the context of the proposed interest limitation rules, this approach would mean either all interest deductions are allowed or all interest deductions are denied. This could lead to some harsh results, where a few square metres could result in all interest deductions being denied, or interest deductions in relation to residential property being inappropriately provided.

Example 2: Dual purpose buildings under “predominant use” business premises carveout

Tāmami owns a two-story building with mixed residential and commercial use. The ground floor is a clothing store and the upper storey is rented out as long-term residential accommodation. The ground floor is on one title and the upper storey is on a separate title. The ground floor is not land with a dwelling on it and is therefore out of scope of the proposed interest limitation rules. Tāmami would be permitted to claim interest deductions in relation to the ground floor. However, he would not be able to claim interest deductions in relation to the apartment on the upper storey as this is land with a dwelling on it.

David owns a similar building next door with mixed residential and commercial use. However, the whole building is on a single title. He rents the ground floor to a fish-and-chip shop, while the upper storey is an apartment which David rents out separately. Under the rules for apportionment, the ground floor for the fish and chip shop accounts for 45% and the upper storey 55%. As the business premises exclusion for the bright-line test requires that the land be used “predominantly” for business purposes, the land does not meet the requirements for the carveout. David would not be able to claim any interest deductions if the same predominant use test were adopted for interest limitation.

Next door, Yumei owns a similar two-storey building with mixed use. Her ground floor is rented by a real estate agency as their office, while the upper storey is again an apartment which she rents out. However, in Yumei’s building, the real estate agency office accounts for 55%, with the apartment only accounting for 45%. The land would qualify as business premises under a predominant use test and Yumei would be able to claim all of her interest expense as deductions.

- 2.67 The Government is interested in receiving feedback on whether an apportionment calculation allowing for interest deductions in relation to the business premises of a dual-purpose building may be preferable over the all-or-nothing approach.
- 2.68 The current law already contains rules regarding apportionment, which generally focus on time and space. The Government’s starting position is to follow general principles used in income tax law for apportionment but would be interested in feedback on other feasible methods of apportionment.
- 2.69 There is an additional issue of whether a specific definition of “business premises” would be required for the purposes of the interest limitation regime. The term is already defined in section DD 11 of the ITA for the purposes of entertainment expenditure and the land sales provisions. In addition, the exclusion from the land sale rules in section CB 19 of the ITA contains additional requirements.

DD 11 Some definitions

[...]

business premises—

- (a) means the normal business premises or a temporary workplace of the person (or an associate):
- (b) does not include premises or a workplace established mainly for the purpose of enjoying entertainment.

CB 19 Business exclusion from sections CB 6 to CB 11

Exclusion

- (1) Sections CB 6 to CB 11 do not apply to a disposal of land by a person (person A) if—
 - (a) the land is the premises of a business; and
 - (b) person A acquired and occupied, or erected and occupied, the premises mainly to carry on a substantial business from them....

Meaning of land

- (3) In this section, land includes land that—
 - (a) is reserved, with the premises, for the use of the business; and
 - (b) is of an area no greater than that required for the reasonable occupation of the premises and the carrying on of the business.

Questions for submitters

- Would an all-or-nothing predominant use approach for business premises used by the bright-line test appropriate for interest limitation, or would an apportionment approach be more suitable?
- How could an apportionment approach work?
 - Should it follow general tax principles, or is there another approach that might be more appropriate?
 - Are there any apportionment calculations regularly done by landowners for other purposes (for example, insurance and mortgages) that might be useful in this context?
- How might “business premises” be defined for the purpose of interest limitation?
 - To what extent is it possible to reuse the definitions outlined above for this purpose? What issues might this cause?

Employee accommodation

2.70 Some types of employee accommodation may already be implicitly excluded from the scope of the interest limitation rules, based on the Government’s proposal to use existing definitions as a starting point. Where employee accommodation is provided on farmland, the accommodation would be excluded. Where employee accommodation is on land that would qualify for an all-or-nothing business premises exclusion, the employee accommodation would also be excluded.

2.71 However, the employee accommodation may not always be on the same land as the farmland or business premises.

- 2.72 For this reason, the Government considers employee accommodation to be a separate category that may warrant further analysis. Businesses provide employee accommodation for any number of reasons. In some instances, the accommodation could be specifically designed to suit the needs of the business, while in other cases, the business may simply acquire standard residential property for the provision of employee accommodation.
- 2.73 Employee accommodation is not generally substitutable for owner-occupied housing and would not compete with regular residential property, placing it outside the scope of the Government's objectives. While sometimes the employee accommodation could be suitable for owner-occupiers, it may not be practicable to accurately distinguish between different types of employee accommodation based on structural characteristics without creating complexity and compliance costs.
- 2.74 For this reason, the Government proposes a carveout for all employee accommodation, with satisfactory integrity measures to minimise the potential for abuse. The residential ring-fencing rules contain a specific carveout for employee accommodation in section EL 13 of the ITA. The Government is interested in feedback on whether this would be an appropriate starting point for designing a carveout for employee accommodation under the proposed interest limitation rules and what other integrity issues may need to be considered.

EL 13 Exclusion for property provided as employee accommodation

Accommodation connected with employment or service

- (1) Section EL 4 does not apply to residential land of a person that is property that a person provides to their employees or other workers for accommodation in connection with their employment or service.

Associated employees or workers

- (2) Subsection (1) does not apply if the employees or other workers are associated with the person, unless it is necessary for the person to provide the accommodation because of the nature or remoteness of a business carried on by them.

Questions for submitters

- Should a carveout for employee accommodation be provided under the interest limitation rules?
- Does the employee accommodation carveout in the residential ring-fencing rules provide a useful basis for an interest limitation carveout? Can you see any issues with using these rules?
- What integrity issues might arise from carving out employee accommodation, and how could these be mitigated?

Student accommodation

- 2.75 The Government is also considering a carveout for purpose-built student accommodation (for example, halls of residence). These residential buildings do not compete with owner-occupied accommodation and would not typically be set up in a way that would be conducive to owner-occupation. This category of accommodation is not connected with the Government's objective of tilting the playing field toward owner-occupiers.
- 2.76 Depending on the facts and circumstances, student accommodation could be covered under the existing carveout for hostels in the definition of a dwelling (paragraph (b)(ii)). Therefore, in some situations, a carveout may not actually be required.
- 2.77 However, the Government considers that certainty could be provided with a specific carveout for specified types of student accommodation.
- 2.78 A potential carveout for student accommodation could be based on the requirements in sections 5(1)(h) and 5B of the Residential Tenancies Act 1986, reproduced below:

Section 5(1)(h)

- (1) This Act shall not apply in the following cases:

[...]

- (h) where the premises are used to provide accommodation to students—

- (i) at a school hostel (being a hostel within the meaning of section 10(1) of the Education and Training Act 2020); or
- (ii) in accordance with the requirements of section 5B:

Section 5B

- (1) For the purposes of section 5(1)(h)(ii), this Act does not apply to premises if—

- (a) the premises are used to provide accommodation exclusively for students of 1 or more tertiary education providers; and

- (b) the premises are owned or operated by a person (an accommodation provider) who is—

- (i) a tertiary education provider; or

- (ii) a person who has entered into a written agreement of the kind described in subsection (5) with each tertiary education provider whose students are accommodated at the premises; and

- (c) the accommodation provider complies with subsections (2) to (4).

- (2) The accommodation provider must provide services to the students accommodated in the premises that are over and above the services that a landlord must provide under Part 2 or 2A.

- (3) The accommodation provider must have in place house rules that aim to create an environment that fosters personal development and encourages a sense of community and association with fellow students.
- (4) The accommodation provider must take all reasonable steps to ensure that prospective and current student tenants are made aware of, and have access to copies of, the house rules.
- (5) An agreement referred to in subsection (1)(b) is one that sets out—
 - (a) the rights and obligations of the accommodation provider and the tertiary education provider; and
 - (b) a dispute resolution process by which disputes between the accommodation provider and the tertiary education provider may be resolved.
- (6) In this section, tertiary education provider has the same meaning as in section 10(1) of the Education and Training Act 2020.

2.79 By linking into an existing regulatory framework, the risk of abuse is reduced and appropriately targets the carveout. Additionally, it reduces concerns about whether a carveout could create an incentive to convert residential apartment buildings into student accommodation.

Questions for submitters

- Should a specific carveout for student accommodation be provided? Is it necessary?
- Are there any issues with using the regulatory framework in sections 5(1)(h) and 5B of the Residential Tenancies Act 1986 as a basis for this carveout?
- Could a carveout encourage the conversion of regular residential rental properties into student accommodation? How could this risk be mitigated?

Short-stay accommodation substitutability issues

2.80 The general intent is for both long-term residential accommodation and property that is easily substitutable for long-term residential accommodation to be included in the scope of the interest limitation rules. This covers standard housing that is neither owner-occupied nor rented on a long-term basis, but instead is used to provide short-stay accommodation. However, there are certain types of short-stay accommodation that are neither traditional commercial accommodation covered by the legislated carveouts (for example, a hotel or motel) nor a standard residential property (for example, a house or apartment).

2.81 Where such places cannot be refitted into houses suitable for residential living (for instance, if there is not enough space to install the necessary amenities),

they are not suitable for long-term habitation and may not therefore be considered substitutable with property available to owner-occupiers. As such, they arguably fall outside the intended scope of the interest limitation regime.

- 2.82 The Government is interested in submissions on whether a specific carveout could be designed in such a way as to distinguish this type of short-stay accommodation from short-stay accommodation provided in a traditional house or apartment that could be suitable for private owner occupation. In some cases, these properties would not satisfy the legal definition of dwelling and a carveout would simply provide additional certainty.

Questions for submitters

- Should short-stay accommodation that is not substitutable for long-term accommodation be carved out from the interest limitation rules and why?
- How could this carveout be designed to avoid capturing short-stay accommodation that could be substitutable for owner-occupied housing?
- How could this carveout be designed to prevent short-stay accommodation that is substitutable for owner-occupied housing from being converted so that it is not substitutable?
- How could a carveout be designed to reflect a sense of commercial scale akin to a hotel or motel?

Serviced apartments

- 2.83 The exclusion of serviced apartments from the definition of dwelling in the ITA was originally introduced for the purposes of depreciation of commercial fitout. Serviced apartments are specifically carved back in for the bright-line test.
- 2.84 In some situations, a serviced apartment may be more akin to a hotel, but in others, the physical structure may mean that it is more like a residential apartment building.
- 2.85 The Government is concerned that a carveout allowing owners of serviced apartments to claim interest deductions may lead to the conversion of regular apartments into serviced apartments, which would reduce effective housing supply. This would be counter to the Government's intent and stated objectives.
- 2.86 The Government is interested in exploring whether a carveout for serviced apartments that more closely resemble hotels might be warranted, and how such a carveout might be constructed to prevent standard residential apartments from being converted into serviced apartments.

Māori collectively-owned land

- 2.87 The Crown has an obligation under the principles of Te Tiriti o Waitangi/ the Treaty of Waitangi to understand the impact of proposed policy changes on Māori and balance the consideration of any impacts for Māori with broader public policy objectives, including the Government’s stated housing objectives outlined in paragraph 1.2 of this discussion document.
- 2.88 The Government is considering issues that relate to Māori freehold land and Māori customary land (Māori land). These issues extend to general title land collectively owned by Māori used to provide residential rental accommodation, either to whānau or the general public. Māori collectively-owned land cannot generally be bought and sold, and in most instances would not be considered residential land if it does not have a dwelling on it or is not bare land that may be used for erecting a dwelling under rules in the relevant operative district plan.
- 2.89 The Government acknowledges that using concepts from the bright-line test could result in Māori land being impacted by the proposed interest limitation rules.
- 2.90 The Government notes that rental income derived (and interest expenses incurred) through a registered charity (registered under the Charities Act 2005) should not give rise to tax implications arising under the proposed interest limitation rules, given the tax exemption that applies to these entities. Therefore, this section is mainly relevant where a different taxpaying structure is used – for example, a company or trust, whether or not it is a Māori authority.

Papakāinga housing

- 2.91 The Government is interested in understanding the potential impact on papakāinga housing, which can include both rental accommodation and “owner-occupied” accommodation,⁴ sited on Māori land or general title land. Particularly on Māori land, papakāinga housing does not compete with general owner-occupied housing and a carveout may be appropriate.
- 2.92 The aims of papakāinga housing include providing whānau with quality affordable housing and promoting Māori community development. Papakāinga housing therefore plays an important role in supporting and fostering cultural identity and financial stability. The Government is considering how the interest limitation rules can be designed to not hinder this.
- 2.93 A carveout would not be required for owner-occupied papakāinga due to existing rules that do not permit interest deductions to be taken against personal income, like salary and wages. The interest limitation rules would not change this current treatment.

⁴ Owner-occupied papakāinga on Māori land is not actually transferred to the individual, but instead they are provided an occupation order (through the Māori Land Court) and they simply own the dwelling on the land. Where an occupation order is not required, a licence to occupy is generally provided by the relevant land trust.

- 2.94 However, where the papakāinga housing is rented out, there may be interest expenditure which relates to the acquisition or construction of the papakāinga development. The interest limitation rules could therefore impact the ability to deduct interest expenses from the relevant rental income for income tax purposes.
- 2.95 The Government seeks comment on the issues related to kaumātua rental housing and financing structures used to support kaumātua in this way. Papakāinga housing is not necessarily age restricted, but a papakāinga development may include specific housing set aside for kaumātua. Alternatively, kaumātua housing may be separate to a papakāinga development and includes legacy housing stock. The objectives of kaumātua housing go beyond the simple provision of housing and acknowledge the important role elders have in society. Therefore, specific consideration is being given to kaumātua housing.
- 2.96 There are additional chapters in this discussion document that may be relevant for the construction of papakāinga and kaumātua housing, including the chapters relating to new builds (chapters 7-9) and the chapter on development activity (chapter 6). The treatment of Māori collectively-owned land is also considered in chapter 10 on the design of rollover relief.

Questions for submitters

- Would a carveout for papakāinga housing be appropriate to support the aims of papakāinga and the Government's wider housing objectives?
- Is papakāinga housing straightforward to identify?
 - Are there certain characteristics that could assist with identification?
 - How common is it for papakāinga housing to be provided on general title land (as opposed to Māori land)?
 - Is it possible to easily differentiate between papakāinga housing on general title land from standard rental properties?
- Can housing on Māori land be rented to non-whānau, and how common is this?
- How are papakāinga housing developments structured and financed?
 - How common is it for papakāinga housing to be provided through a registered charity?
 - To what extent is interest incurred on loans related to papakāinga housing?
 - Are bank loans the most common form of debt finance used? What other forms of debt finance are used?
- Should separate consideration be given to a carveout for kaumātua housing?
 - Are there issues that need to be considered in relation to legacy kaumātua housing?
 - Is it common for interest expenses to be incurred in the provision of kaumātua housing?
 - How could the interest limitation rules impact a decision to take out a loan to upgrade existing or construct new kaumātua housing?
- Beyond papakāinga and kaumātua housing, what other ways are iwi and hapū supporting whānau through housing, in particular the provision of rental accommodation?
 - What structures are used? (for example, joint ventures)
 - How is such housing financed?

Chapter 3

Entities affected by interest limitation

Companies

- 3.1 Companies are generally allowed deductions for interest incurred without needing to trace the use of their borrowed funds (see section DB 7 of the Income Tax Act 2007).⁵ The Government proposes to override the general rule in section DB 7 for residential investment property owned by close companies and residential investment property-rich companies. Accordingly, if a close company or residential investment property-rich company borrowed for residential investment property purposes, its interest deductions would be limited to the extent that its borrowings are traced to residential investment property purposes (unless an exemption applies). Section DB 7 would still apply to the extent that interest expenditure is not traced to residential investment property.

Example 3: Close company acquiring residential investment property

Harry is the sole shareholder in a company, MixedCo. MixedCo borrows \$800,000 from a bank at a 5% interest rate.

MixedCo uses \$300,000 of the borrowed funds to acquire a residential investment property, which it rents out. The remaining \$500,000 is applied to business purposes unrelated to the residential investment property.

MixedCo's interest deductions on the \$300,000 portion of the loan will be subject to limitation.

- 3.2 This override of section DB 7 would mean that taxpayers cannot get around the interest limitation proposal by using close companies to borrow to acquire residential investment property. It is also more neutral in that it will not create a tax incentive to form widely held companies to debt-fund residential property investments.
- 3.3 The Government does not propose to extend the interest limitation rule to all companies, in order to reduce compliance costs for companies whose main business does not involve residential investment property. Tracing can be difficult for companies with many sources of funds and a variety of different assets.⁶ If a company holds relatively small amounts of residential investment property, it would usually be able to obtain full deductibility of interest under the tracing approach anyway by ensuring all borrowing is used to fund non-

⁵ This is subject to some exceptions, such as for the mixed-use asset rules: section DB 7(6B) of the Income Tax Act 2007.

⁶ Although tracing may also be difficult for some close companies and residential investment property-rich companies, it is important to ensure that taxpayers cannot circumvent the interest limitation proposal by acquiring residential investment property through close companies. It will also usually be easier for shareholders in close companies to restructure to ensure that interest deductions for other business purposes are not effected (for example, shareholders may set up a separate sister company to hold any residential investment property).

residential assets. Moreover, companies that hold small amounts of residential investment property (relative to their total assets) are unlikely to contribute significantly to high house prices.

What is a “close company”?

- 3.4 A “close company” is a company where five or fewer natural persons or trustees directly or indirectly hold more than 50 per cent of the company.⁷
- 3.5 The “close company” definition treats all associated natural persons as a single person but does not apply that same treatment to trustees of trusts settled by the same person (or their associates). It might therefore be possible for a person to avoid having a “close company” by settling multiple trusts and splitting the share ownership among those trusts, while still maintaining overall control of the company.
- 3.6 The Government therefore proposes to amend the definition of “close company” by treating all trustees of trusts settled by the same person (or their associates) as a single trustee.

What is a “residential investment property-rich” company?

- 3.7 A company would be residential investment property-rich if, at any time during the income year,⁸ the company’s residential investment property percentage exceeds a specified threshold. A company’s residential investment property percentage would be calculated using the following formula, which compares a company’s residential investment property with its total assets:

$$\frac{\text{value of residential investment property}}{\text{value of total assets}}$$

- 3.8 The Government proposes to use the same 50 percent (by value) threshold that is used in the “residential land-rich entity” definition for the residential loss ring-fencing rules.⁹ The “residential investment property-rich” threshold would apply on a company-by-company basis, but companies that are part of a tax consolidated group would be treated as a single company. Companies that are not close companies with a residential investment property percentage below this 50 percent threshold will continue to be allowed their interest deductions unless one of the exceptions to section DB 7 applies. This would mean that a non-close company with some minor residential investment property holdings (as compared with assets for its other, dominant, business or investment activity) could disregard the rules in this discussion document.

⁷ Section YA 1.

⁸ The reason this is applied at any point in the income year, rather than only at the end of the income year, is to ensure that taxpayers cannot avoid the interest limitation proposal by changing the company’s assets portfolio at year-end. The purpose of this threshold is to ensure that companies with minor or incidental holdings of residential investment property are not subject to interest limitation, and such companies are unlikely to ever exceed the threshold.

⁹ For clarity, although the current definition of “residential land-rich entity” does not extend to widely held companies, officials propose that all companies would have to apply tracing if they exceed this “residential investment property-rich” threshold.

3.9 The “value of residential investment property” in the formula refers to the value of in-scope residential property (as discussed in chapter 2) owned by a company. An issue that arises is how the following types of assets are treated for the purposes of the “residential investment property-rich” threshold:

- ownership interests in residential investment property-rich companies;
- new builds (see chapters 7 and 8); and
- residential investment property subject to the development exemption (see chapter 6).

Ownership interests in residential investment property-rich companies

3.10 The definition of a “residential land-rich entity” in the residential loss ring-fencing rules looks at the value of residential land owned by an entity, whether directly or indirectly.¹⁰ The Government proposes a simpler approach, which is to treat all ownership interests (for example, shares) in a residential investment property-rich company as “residential investment property” for purposes of the “residential investment property-rich” threshold. This mitigates the need to “look through” chains of companies to determine the value of residential investment property held by each subsidiary (at least in cases where it is clear whether or not the subsidiary is residential investment property-rich, which is expected to be most cases).

Example 4: Residential investment property-rich threshold – shares in other companies

At the end of the 2023 income year, A Ltd’s total assets consist of the following:

- residential investment property with a value of \$400,000;
- commercial property with a value of \$500,000;
- 50% of the shares in B Ltd with a value of \$300,000.

At the end of the 2023 income year, B Ltd’s total assets consist of:

- residential investment property with a value of \$400,000; and
- commercial property with a value of \$200,000.

B Ltd’s residential investment property percentage is $\$400,000/(\$400,000 + \$200,000) = 66.7\%$. B Ltd is therefore a residential investment property-rich company. To work out if A Ltd exceeds the residential investment property-rich threshold, its \$300,000 holding in B Ltd is treated as “residential investment property”.

A Ltd’s total value of residential investment property is therefore $\$400,000 + \$300,000 = \$700,000$, and its total assets are \$1.2m. Its residential investment property percentage is therefore $\$700,000/\$1.2m = 58.3\%$. A Ltd is a residential investment property-rich company.

New builds

3.11 New builds are residential investment property and should be treated as such for purposes of the “residential investment property-rich” threshold. The carveout for companies that are not “residential investment property-rich” is

¹⁰ Section EL 3.

aimed at removing compliance costs and providing certainty for companies that hold residential investment property incidental to their core business. A company with an asset portfolio comprising 60 per cent new builds and 40 per cent existing rental properties still has a core business involving residential investment property and should not be allowed to obtain interest deductions on borrowings used for its existing rental properties; it should still have to trace to work out which interest deductions are limited.

- 3.12 In addition, if the new build exemption is for a fixed time period (see paragraphs 8.20 and 8.21 in chapter 8), a company that only acquires new builds will have to work out how much of its interest deductions are limited when some of its properties no longer qualify for the new build exemption. It may not be able to do this unless it had traced its borrowings to the properties initially.

Residential investment property subject to the development exemption

- 3.13 The development exemption is proposed to apply on a property-by-property basis (see chapter 6). A property that qualifies for the development exemption may later stop qualifying for it (for example, if development ceases). For reasons similar to those outlined in paragraph 3.11 for new builds, officials propose that residential property under development should still be considered “residential investment property” for purposes of the “residential investment property-rich” threshold.
- 3.14 If all residential investment property held by a developer company is covered by the development exemption, it would be allowed all of its interest deductions anyway (regardless of whether or not it is “residential investment property-rich”). If the developer company holds a few rental properties subject to limitation, interest expenditure on borrowings traced to those properties will be limited.

Valuation

- 3.15 The Government proposes to determine the asset values for the residential investment property percentage calculation using the same rules as those applied for residential loss ring-fencing (section EL 19), with one possible exception.
- 3.16 For land, the value would be the later of its most recent capital or annual value as set by a local authority or its acquisition cost (or its market value if acquired from an associate). For depreciable property, the value would be the property’s adjusted tax value. For all other property, however, officials consider a change may be desirable. Instead of requiring taxpayers to use market value for all “other property” (as required by section EL 19(1)(c)), there may be merit in allowing taxpayers to use accounting or tax book values where market value cannot be easily ascertained. Submissions are invited on this potential change.

Feedback on companies

Questions for submitters

The Government invites submissions on the proposals outlined above and is particularly interested in:

- Does treating new builds and residential property covered by the development exemption as “residential investment property” for purposes of the “residential investment property-rich” threshold cause issues for any developer companies? If so, what are those issues?
- Do you prefer to use accounting or tax book values for calculating the residential investment property percentage for assets other than land, improvements and depreciable property? Why?

Kāinga Ora

- 3.17 The Crown agency, Kāinga Ora-Homes and Communities (Kāinga Ora), provides public housing for people in need of assistance. It does this through its own housing and through housing held by its wholly-owned subsidiary, Housing New Zealand Limited.
- 3.18 Together, public housing and community housing are referred to as social housing. Registered community housing providers are separate from the Crown, and many are charities and therefore exempt from income tax. Other community housing providers may be exempt under section CW 42B of the Income Tax Act 2007 (ITA). Since Kāinga Ora is not a charity or a community housing provider, it does not qualify for these exemptions. The Government therefore proposes to exclude Kāinga Ora and its wholly-owned subsidiaries from the interest limitation rules.
- 3.19 Kāinga Ora also undertakes property development and building activity through its other wholly-owned subsidiary, Housing New Zealand Building Limited. These activities would likely be exempt from the interest limitation proposal under the development exemption (see chapter 6) even in the absence of an exclusion.

Other organisations

- 3.20 The Government does not propose to exclude other entities from the interest limitation rule, though exemptions are proposed for land being developed and for new builds (see chapters 6, 7 and 8).

Questions for submitters

- Are there other organisations that should not be subject to the interest limitation proposal?
- If so, please provide a description of those organisations' activities and explain why an exclusion is appropriate. In particular, please explain why an exclusion should apply to the organisation as a whole, rather than to the type of land held by, or activities undertaken by, that organisation. Exclusions for particular organisations, rather than for types of land or activities, are more likely to be appropriate when the organisation's functions are prescribed or circumscribed by law.

Chapter 4

Interest allocation: how to identify which interest expenses are subject to limitation

Introduction

- 4.1 In tax law, whether a deduction is allowed for expenditure generally depends on the purpose of the expenditure. Generally, expenditure is only deductible if it has a sufficient connection or “nexus” with assessable income. For interest expenses, the relevant issue is what the corresponding loan (under which the interest is paid) was used for.¹¹ This can be described as a “tracing” approach as the value of the borrowed funds are traced to the value of any asset acquired using those funds or, if the funds have been applied to an expense, the cost of that expense.
- 4.2 If a taxpayer uses a loan for non-taxable purposes, such as to buy their family home, or private beach house, or to fund their holiday, they are not allowed a tax deduction for interest on that loan. The Government generally proposes to follow the same tracing approach for the interest limitation rules such that interest on loans used for residential investment purposes¹² will also become non-deductible.

Why tracing is the preferred approach

- 4.3 Tracing is already the approach generally used by taxpayers (other than companies) to determine when interest expenses are deductible. The vast majority of taxpayers owning residential investment properties are not companies.¹³
- 4.4 Using a tracing approach means that taxpayers borrowing for non-residential investment purposes will be unaffected by the interest limitation proposal. This accords with the Government’s desire to ensure that the proposal will not affect loans for non-residential investment purposes.

How the tracing approach works

- 4.5 The tracing approach works by identifying what money has been borrowed by a taxpayer and determining what that money has been used for. If borrowings have been used for residential investment purposes, interest deductions on those borrowings will no longer be deductible (subject to exemptions such as

¹¹ The position is different for companies with interest expenditure. Under section DB 7 of the Income Tax Act 2007, interest expenditure for companies is generally deductible, with some exceptions (that is, companies usually will not have to trace).

¹² This term is intended to cover purposes relating to deriving income from residential investment property (unless a specific exemption applies) and includes, for example, costs of acquiring, selling, or holding a residential investment property.

¹³ Based on 2019 returns, around 96% of taxpayers returning rental income were not companies (excluding look-through companies, which are not treated as companies for tax purposes).

for new builds and developers). Borrowings for residential investment purposes include not just the borrowings to fund the purchase of a residential investment property, but also borrowings to fund expenses incurred in deriving rental income (for example, borrowings to pay for repairs and maintenance, rates, insurance and property manager fees – the underlying expenses would still remain deductible, though).

- 4.6 Importantly, under tracing, deductibility does not depend on the security or collateral for the loan. This is because the security for the loan often has little or no relation to the purpose of the loan. Mortgage agreements also often provide that any security given by the borrower secures any loans the borrower has with the particular bank, as well as any future loans the borrower may have with that bank.

Example 5: Loan used for residential investment property

Avon owns a commercial property valued at \$1.5m. He decides to buy a residential investment property for \$400,000 in November 2021. Avon borrows \$400,000 from the bank to pay for the residential property. The loan is secured against his existing commercial property only.

Because Avon used the \$400,000 loan to buy a residential property, he cannot claim interest deductions on the \$400,000 loan. The fact that the loan is secured against the commercial property is irrelevant.

Example 6: Loan used for business purposes

Maia owns a residential investment property valued at \$500,000. She takes out a \$200,000 loan, secured against her residential investment property, to buy a food truck and catering equipment to start a business.

Maia will be allowed to claim interest deductions incurred under her \$200,000 loan, because it was used for non-residential business purposes.

- 4.7 A taxpayer may own some assets for which interest deductions may be allowed (for example, new builds, other business assets) alongside other assets for which interest deductions may not be allowed (for example, a family home, residential investment property acquired on or after the “effective date” of 27 March 2021). For some assets such as pre-27 March residential investment property, partial interest deductions may be allowed.
- 4.8 Taxpayers holding such a variety of assets will often take care to ensure their interest deductions for new builds and other business assets can be clearly traced to those assets. One way to do this is to keep loans for different types of assets separate. For example, instead of taking out a single \$1m loan to buy a new build for \$500,000 and a post-27 March property for \$500,000, a taxpayer can take out two separate \$500,000 loans to make tracing easier.

Example 7: Tracing with multiple assets

Neo has an existing loan of \$375,000 that he used to buy a residential rental property in Stratford.

In May 2022, Neo wants to buy two residential apartments - one in Auckland and one in Hamilton. The Auckland property is a new build with a purchase price of \$500,000. The Hamilton property is not a new build, with a purchase price of \$400,000. He has existing savings of \$350,000 but needs to borrow a further \$550,000 from the bank to fund the two purchases.

He uses his existing savings to put down a \$100,000 deposit for the new build and borrows the remaining \$400,000 from the bank. He uses his remaining savings of \$250,000 along with a further \$150,000 bank loan to buy the Hamilton property.

Under the interest limitation rule, the treatment of interest deductibility for each of the properties is as follows:

- Interest on the existing \$375,000 loan used to buy the Stratford property will be subject to phasing.¹⁴
- Interest on the \$400,000 loan used to buy the Auckland new build will be fully deductible (in accordance with the new build rules).
- Interest on the \$150,000 loan used to buy the Hamilton property will not be deductible.

If Neo had funded his purchases differently, his interest deductions would be different. For example, if he had used more savings (and less debt) to fund his purchase of the new build, his interest deductions would be less.

Tracing and change of use

- 4.9 Consistent with current law, if the use of the borrowed funds changes, the deductibility of interest may also change as the funds are “traced” to a new use.

Example 8: Change of use of borrowed funds from business to residential

On 1 April 2022, Billy borrows \$50,000 to buy a vehicle to be used solely for his business. On 1 October 2022, Billy sells his business vehicle and uses the sale proceeds to pay for repairs, rates, insurance and property manager fees for his residential rental property.

Billy can deduct interest on the loan incurred up to 30 September 2022. He will not be able to deduct interest on the loan after that.

Tracing and repayments

- 4.10 When a loan is applied to different purposes, some of which are deductible and some of which are not, there is a question about how repayments of that loan should be allocated — whether they should be allocated to the deductible or non-deductible purposes.

¹⁴ Refer to chapter 1 for detail on how interest deductions will be phased out for pre-27 March property.

Example 9: Partial repayment of a loan used for both deductible and non-deductible purposes

Bharat has an overdraft facility with his bank for \$50,000, with a balance of \$0 as at 1 April 2022. The bank calculates interest daily but charges it monthly at the end of each month to the same overdraft facility, increasing the amount owing under the facility.

On 1 May 2022, Bharat draws down \$20,000 to buy a van for his plumbing business. Interest on the \$20,000 drawdown should be fully deductible (assuming the van is used exclusively for the business). On 31 May, interest of \$50 is added to the amount Bharat owes under the facility.

On 1 June 2022, Bharat draws down another \$10,000 to pay for a new fence for his residential rental property. Interest on the \$10,000 drawdown will not be deductible under the new interest limitation proposal. On 30 June, interest of \$75 is added to the amount Bharat owes under the facility.

On 28 August 2022, Bharat makes a deposit of \$10,000 into his overdraft facility. The question is how the \$10,000 should be allocated. Should it be applied first to the interest of \$125, or should it reduce Bharat's deductible \$20,000 loan by \$10,000, or should it eliminate his non-deductible \$10,000 loan?

- 4.11 This issue already exists. A sole trader may use an overdraft facility for both business and private purposes. There is no statutory ordering rule prescribing how repayments under such a facility should be allocated for tax purposes. Instead, relevant case law applies.¹⁵
- 4.12 Given the complexity of the case law in this area, a statutory ordering rule for tax purposes may have some merit, but is not a priority for this reform.

Feedback on tracing

Questions for submitters

- Do you agree with the proposed approach to generally rely on the existing law on tracing, except where it would cause transition issues? (Transition issues are discussed at paragraphs 4.17 to 4.40.)
- Are there other issues with applying tracing that have not been identified in this discussion document? The Government is interested in issues that are particular to interest limitation, and not issues that already exist more generally.

Refinancing

- 4.13 While interest on new loans for residential rental properties will generally not be deductible under the proposals an exception to this will be for refinancing

¹⁵ See for example *Falk v Haugh* (1935) 53 CLR 163, *Devaynes v Noble* (1816) 35 ER 781 (*Clayton's case*); *Foskett v McKeown* [2001] 1 AC 102 (HL) and *Re Registered Securities Ltd* [1991] NZRL 545 (CA).

pre-27 March loans that apply to property held (or acquired) before 27 March 2021.

- 4.14 When a residential rental property owner draws down a new loan to repay a pre-27 March loan, it is proposed that the treatment of interest on the existing loan will carry through to the new loan. As well as being consistent with the tracing approach, this proposal will allow borrowers to restructure their funding sources when it is commercially sensible to do so. The proposed refinancing exception is largely consistent with existing case law but the Government proposes a specific legislated exception to ensure the phased transition and any other factors stay consistent with the existing loan.
- 4.15 If a new loan is larger than the existing loan, a tracing approach, as outlined will need to be applied to determine whether the interest on the additional lending is deductible or not. If the loan has been used solely for pre-27 March residential rental property any break costs added to the loan will not result in deductible interest.
- 4.16 One exception to the tracing proposals for refinancing pre-27 March loans used to acquire pre-27 March residential property is in the unlikely scenario where a residential rental property that has been funded by a New Zealand Dollar (NZD) loan is refinanced with a loan denominated in another currency. The Government proposes that refinancing an NZD loan with a loan in another currency will also not be subject to any refinancing exception. Accordingly, any interest incurred or foreign exchange movements on these foreign currency loans would not be deductible or assessable. This is consistent with the proposed treatment of foreign currency loans over New Zealand residential rental property (refer to paragraphs 4.45 – 4.52).

Feedback on refinancing

Questions for submitters

- Do you agree that a new loan to refinance a pre-27 March loan would benefit from a specific provision?
- Are there any commercial reasons a loan that is in New Zealand dollars would be restructured to a loan in a foreign currency?
- Are there other issues with refinancing that we have not considered?

Transition issues

- 4.17 While there are generally no proposed changes to the existing law around tracing, there are two situations involving transition for which particular rules are proposed.
- 4.18 The first situation involves pre-27 March loans used to finance income producing residential and non-residential assets. When such loans were taken out, the borrower did not need to trace their borrowings, and it may now be difficult or impossible for them to trace their borrowed funds retrospectively

to work out which interest deductions are limited. Two alternative rules are proposed to address these issues. These rules would only need to be applied once to allocate pre-27 March loans to existing assets. After pre-27 March loans have been allocated accordingly, the tax treatment of interest deductions would follow on from that allocation.

- 4.19 The second situation involves commonly offered loan products that raise specific issues. These issues can occur for transactions made from 27 March 2021 throughout the entire transitional period (during which phased deductions may be allowed). Examples of this are revolving credit facilities and possibly offset accounts. A high water mark proposal aimed at these issues is outlined in paragraphs 4.33 – 4.40.

Pre-27 March loans that cannot be traced

- 4.20 As set out above, the interest limitation proposal may give rise to difficulties for taxpayers who were previously not required to trace, and who may therefore not hold the records necessary to show that a pre-27 March loan was applied to a particular business use as opposed to a residential-related use.

- 4.21 Two alternative rules are proposed for taxpayers to allocate their pre-27 March loans across their assets.

- *Option 1: Apportionment.* Under this option, taxpayers may apportion their pre-27 March loans across their assets based on their original acquisition cost, including any improvements. Apportioning based on original cost (including improvements) instead of, for example, market value makes sense because the aim of apportionment in this context is to provide some basis to work out how funds are deemed to have been applied. Taxpayers should also be able to work out their original cost relatively easily, whereas market value can be costly to work out (for example, if a taxpayer owns unlisted shares). We propose that apportioning should be done based on loan balances as at 26 March 2021, with repayments of any apportioned loans after that date allocated to assets in the same proportions. Increases in debt balances on or after 27 March 2021 would represent new drawdowns (not pre-27 March loans), for which tracing should be applied.
- *Option 2: Stacking.* Under this option, taxpayers would allocate their pre-27 March loans, excluding any loans traced to private purposes,¹⁶ first to assets that are not residential investment properties. The rationale for this approach is that well-advised taxpayers would be able to restructure to achieve the same tax outcome under tracing anyway.¹⁷ Allowing this tax outcome without requiring a restructure would therefore reduce compliance costs and help taxpayers who do not have

¹⁶ Where loans have been applied to both taxable and private purposes, taxpayers have always needed to trace to ensure that they do not claim interest deductions for borrowings applied to private purposes.

¹⁷ For example, a taxpayer could sell their non-residential assets to a wholly-owned company for market value, and the company could borrow to acquire those assets. The taxpayer would then use the sale proceeds to repay the pre-27 March loan. As the company's borrowings are traced to the acquisition of non-residential business assets, its interest deductions would be allowed in full (subject to possible application of the general anti-avoidance rule in section BG 1 of the Income Tax Act 2007).

professional advice. For this option, stacking will be based on the market value of assets as at 26 March 2021.

Example 10: Transition of pre-27 March loan

As at 26 March 2021, Tiffany owns two properties, both acquired at around the same time in the 1990s:

- a residential rental property purchased for \$300,000, with improvements of \$100,000 carried out in the 2000s; and
- a commercial rental property, purchased for \$400,000, with no improvements.

She acquired the two properties using a combination of loans and savings. Over the years, Tiffany has refinanced and restructured her loans several times and has made many repayments. As at 26 March 2021, she has a single outstanding loan of \$200,000 and no other debt.

Although Tiffany never used the loans for personal purposes, she did not trace exactly how the borrowed funds were applied to each property in the past and does not have the records to do so now.

Option 1: apportionment based on cost

Under the apportionment approach, 50% (being \$400,000 divided by the total asset costs of \$800,000) of Tiffany's \$200,000 loan is treated as having been used to acquire the commercial property. The remaining 50% of her loan is treated as having been used to acquire the residential property.

From 1 October 2021 until the loan is fully repaid, Tiffany will be able to deduct 50% of the interest expenditure incurred under her loan. The remaining 50% of interest expenditure will be subject to phasing.

Option 2: stacking based on market values

Under the stacking approach, Tiffany's \$200,000 loan is stacked against her commercial property first. Assuming the market value of the commercial property on 26 March 2021 is at least \$200,000, Tiffany can continue to deduct all her interest expenditure under the loan indefinitely.

- 4.22 Where sufficient evidence exists for tracing to be applied, taxpayers will still have the option to trace. The transition approach proposed above will therefore be optional.

Example 11: Transition of pre-27 March loan combined with tracing

As at 1 October 2021, Mikael owns the following assets:

- a family home, acquired in the 1980s for \$200,000;
- a farm, acquired in the 1990s for \$300,000;
- a tractor, acquired in the 2000s for \$60,000;
- a residential rental property, acquired in 2007 for \$400,000; and
- shares in a listed company, acquired in 2010 with a cost base of \$100,000.

As at 1 October 2021, Mikael has the following debt:

- \$100,000 loan, used to acquire the family home and pay for other private expenses;
- \$10,000 loan, used to pay for the tractor; and
- \$400,000 loan, used to pay for the farm and residential rental property and related expenses over the years.

Option 1: apportionment based on cost

Mikael's \$100,000 loan would not be subject to apportionment. Mikael can trace the loan to the purchase of the family home and private expenses. Taxpayers have always needed to trace funds applied to private purposes separately from funds applied to business purposes, and the interest limitation proposal does not change this. Interest on the \$100,000 loan will therefore continue to remain fully non-deductible.

Interest on Mikael's \$10,000 loan will remain fully deductible, as the loan can be traced to the purchase of the tractor.

The \$400,000 loan will need to be apportioned between the farm, shares, and residential rental property (total cost of \$800,000). The portion allocated to residential rental property is 50% (being its \$400,000 cost divided by \$800,000 total cost), with the remaining 50% allocated to the farm and shares.

Mikael can therefore continue to deduct 50% of his interest expenses under the \$400,000 loan. The remaining 50% will be subject to phasing.

Option 2: stacking based on market values

Again, the \$100,000 loan would not be subject to stacking and would remain fully non-deductible.

Interest on the \$10,000 tractor loan would remain fully deductible.

The \$400,000 loan will be allocated to the farm and shares first. As long as the combined market value of the farm and shares as at 26 March 2021 is at least \$400,000, Mikael can continue to deduct all interest expenditure under the \$400,000 loan.

However if, for example, the combined market value of the farm and shares as at 26 March 2021 is \$380,000, Mikael will have to treat interest on \$380,000 of their loan as being fully deductible, with interest on the remaining \$20,000 being subject to phasing.

Feedback on pre-27 March loans that cannot be traced

Questions for submitters:

The approaches proposed above are aimed at making compliance easier for taxpayers who would otherwise have to apply tracing to pre-27 March loans.

- Which of the proposed approaches do you prefer?
- Do you have any suggestions on how the proposed approaches can be made simpler?
- Are there alternative approaches you would prefer? If so, how would that alternative approach work?

Issues caused by specific types of loans and high water mark proposal

- 4.23 Although pre-27 March borrowing to fund a pre-27 March residential rental property will be deductible subject to phasing, the same will not apply to new lending. This can create compliance costs and different treatment for different loan products. This section sets out some of those issues and a proposed concession that seeks to address them.

Revolving credits and other variable loans

- 4.24 A revolving credit facility and an overdraft essentially operates the same way. The borrower has a limit approved by their lender and can withdraw up to this limit without having to seek further approval from the lender. They may also make repayments (deposits) at any time. Revolving credit facilities are often used like chequing accounts, with everyday income and expenses going through that account.
- 4.25 An example of how a revolving credit facility is analysed for tax purposes is provided in example 12. Essentially each time the borrower withdraws money from their facility this must be traced as new lending and, as outlined, any repayments are not necessarily allocated against this new lending or any private lending first. This can, even under current law, result in revolving credit facilities having undesirable tax outcomes when the facility is used to fund a mixture of private and taxable expenditure.
- 4.26 However, if a taxpayer has a revolving credit facility that is only used to fund and operate residential rental property (or other taxable activity) all expenditure would relate to taxable activity so, currently, all interest would be deductible.
- 4.27 Under the interest limitation proposal, interest on loans used for costs related to holding or maintaining a residential rental property will become non-deductible, if the loans are drawn down after 27 March 2021. This rule has the potential to create complexity in some very common situations. The simplest example is a loan to fund the purchase of a pre-27 March residential rental property. Interest on the original amount borrowed would be subject to phasing but if interest on that loan was capitalised after 27 March, so the loan value increased, any interest on that increased balance would not be deductible.
- 4.28 Any expenditure on or after 27 March 2021 made from a revolving credit facility, including all interest charged under that facility, would be treated as new lending. Unless that expenditure is traceable to a deductible use, the interest on that lending would not be deductible after 1 October 2021 in the absence of a special rule.

Example 12: Revolving credit facility and existing residential rental property

On 26 March 2021 Serghei owes \$500,000 on a revolving credit facility used to purchase a residential rental property. Serghei collects rent of \$1,000 each fortnight and is charged interest of \$1,000 per fortnight. There are no other transactions involving this account.

Date	Transaction	Amount	Balance	Balance generating deductible interest
26 March 2021	Opening balance		(\$500,000)	(\$500,000)
31 March 2021	Rent	\$1,000	(\$499,000)	(\$499,000)
31 March 2021	Interest	(\$1,000)	(\$500,000)	(\$499,714) ¹⁸
14 April 2021	Rent	\$1,000	(\$499,000)	(\$498,714) ¹⁹
14 April 2021	Interest	(\$1,000)	(\$500,000)	(\$498,714)
28 April 2021	Rent	\$1,000	(\$499,000)	(\$497,714)
28 April 2021	Interest	(\$1,000)	(\$500,000)	(\$497,714)

Between 26 March and 28 April, the balance of Serghei's revolving credit facility has remained at \$500,000; however, the portion that will generate deductible interest after 1 October 2021 has reduced by \$2,286. If this trend continued by 31 March 2025, when interest deductions are phased out, the balance would still be \$500,000 but the amount generating deductible interest would be only \$395,714.

Offset arrangements

4.29 An offset arrangement operates through a combination of one or more loan accounts and one or more deposit accounts. Interest is charged on the net borrowing across all accounts in the offset arrangement, which allows a borrower to reduce their interest costs and provides similar flexibility to a revolving credit facility. Deposit accounts can be an asset of the borrower or, in some circumstances, an asset of another person such as a close family member.²⁰

4.30 An offset arrangement can function very similarly to a revolving credit facility. For example, instead of owing \$200,000 on a revolving credit facility with an approved limit of \$250,000 a borrower can achieve an equivalent outcome by borrowing \$250,000 and placing \$50,000 back on deposit, offset against the borrowing.

4.31 However, the tax analysis of an offset arrangement is somewhat different. As interest and other expenses can be funded by a withdrawal from a deposit account this would not constitute new borrowing, even though the net loan balance would increase and therefore higher interest would be charged.

¹⁸ Interest incurred on the 10 days before 27 March 2021 will increase the balance eligible to generate deductible interest. The 4 days from 27 March 2021 to 30 March 2021 will not result in deductible interest. \$1,000 has been apportioned by 10/14 to get \$714 (rounded).

¹⁹ This calculation assumes the entire payment is applied to reducing the balance of deductible lending – that is, to the oldest debt first. Refer to discussion on this from paragraph 4.10.

²⁰ Inland Revenue has issued six product rulings for offset products that explain in more detail how these products operate. The most recent is BR Prd 18/03.

Example 13: Offset arrangement

Ari borrows \$50,000 to buy a vehicle for his business, so the interest on the \$50,000 loan will be deductible. Ari operates an offset facility and, over a year, deposits \$50,000 of business profits into a deposit account so interest charged reduces to zero.

Ari withdraws \$50,000 from the deposit account to pay for renovations on his home. As the balance of the deposit account is now zero, the net loan balance returns to \$50,000 and interest is charged. As the loan to purchase the business vehicle has always been outstanding, this interest will continue to be deductible.

- 4.32 Although the amount of total borrowing may remain unchanged, the withdrawal of amounts to apply to residential rental property and the allocation of repayments when there is lending for more than one purpose can lead to complexity. However, it is clear that an offset account can result in more deductible interest than an equivalent revolving credit facility even though both products are very similar economically.

High water mark proposal

- 4.33 While interest on pre-27 March loans will be deductible subject to phasing, any borrowing to fund expenditure on these properties after this date will be subject to interest limitation. This could result in taxpayers being required to trace interest expenditure that is low value relative to the total borrowing, creating high compliance costs. This tracing will only have an impact on tax deductions until the transitional phasing period ends.
- 4.34 Furthermore, if there is no special rule for revolving credit facilities, the outcomes for individual taxpayers in similar circumstances could be quite different depending on their funding arrangements. Taxpayers with offset accounts may have higher interest deductions than taxpayers with revolving credit facilities and taxpayers may have higher interest deductions if they can fund expenditure by deferring principal repayments they would have otherwise made.
- 4.35 To remove this inequity and reduce compliance costs, the Government proposes a high water mark approach. The approach would operate, for each loan, as follows:

Step 1: Determine the high water mark

This is the amount of funding allocated to residential rental property on 26 March 2021 using the proposals outlined elsewhere in this document.²¹

Step 2: Adjust loan balance for private and other deductible expenditure after 26 March²²

The loan balance for the purpose of the high water mark is reduced by any borrowings²³ used to fund private expenditure or deductible expenditure (for example, borrowings for a new build or commercial property)

Step 3: Determine the amount of borrowing that generates deductible interest subject to phasing

- If the adjusted loan balance is lower than the high water mark, all interest on the adjusted loan balance is deductible subject to phasing
- If the adjusted loan balance is higher than the high water mark, interest up to the high water mark is deductible subject to phasing.
- Deductibility of interest on the loan balance above the adjusted balance will depend on the purpose it has been traced to.

4.36 The loan balance for a revolving credit loan would be the amount drawn down rather than the total credit limit that could have been borrowed.

4.37 As with any loan that is applied to multiple purposes which have differing tax treatments the calculation of deductible interest may have to be done each time the balance of the loan changes. The high water mark proposal will reduce this complexity where a loan is only drawn on for the purpose of meeting expenses on pre-effective date residential rental property.

Example 14: Revolving credit facility

On 26 March 2021, Darryl owes \$500,000 on a revolving credit facility to fund his residential rental property. The revolving credit facility has a limit of \$600,000. Darryl does not use this account to fund any private expense or any other deductible uses. His high water mark is therefore \$500,000.

Although the balance fluctuates as he receives rent and pays expenses, by 30 September 2021 the balance is \$480,000. Provided the balance does not go above \$500,000 before the phasing ends at the end of the 2024–25 income year, Darryl will be able to calculate his interest deductions by multiplying all the interest charged on the revolving credit facility by the relevant phasing percentage.

²¹ This would be tracing (if possible) or the transitional proposal outlined above.

²² If the loan has only been used for pre-27 March residential rental property this step is not required.

²³ This would be borrowings net of any subsequent repayments allocated against that borrowing. As the borrowings occur after 27 March 2021 there will usually be no repayments before the end of the phasing period unless the loan has been repaid in full.

Example 15: Private expenditure

On 26 March, Ariana owes \$500,000 on a revolving credit facility to fund her residential rental property. Her high water mark is \$500,000. Although the balance fluctuates as she receives rent and pays expenses, by 30 September 2021 the balance is \$460,000. The balance remains below \$500,000 until Ariana withdraws \$70,000 on 1 April 2023 to buy a car for personal use. This increases the loan balance from \$460,000 to \$530,000. The high water mark remains at \$500,000 but the adjusted loan balance reduces to $\$530,000 - \$70,000 = \$460,000$.

The amount of the loan allocated to the residential rental property is the lower of:

- the high water mark = \$500,000; and
- the actual balance adjusted for private expenditure = $\$530,000 - \$70,000 = \$460,000$

Ariana calculates her deductible interest by multiplying the adjusted loan balance of \$460,000 by the interest rate and the relevant phasing percentage. The portion of the loan used to buy the car (\$70,000) is fully non-deductible.

Example 16: Significant repayment

On 26 March 2021, Kristina owes \$500,000 on a revolving credit facility to fund her residential rental property. Her starting high water mark is \$500,000. Although the balance fluctuates as she receives rent and pays expenses, by 30 September 2021 the balance is \$520,000. As this is above the high water mark Kristina is only entitled to interest deductions on \$500,000 of the loan balance multiplied by the relevant phasing percentage.

On 17 April 2023 she receives an inheritance of \$200,000 which she uses to reduce the balance of the revolving credit facility from \$550,000 to \$350,000. As this is below the high water mark, Kristina can deduct all the interest after applying the 50% phasing reduction for the 2023–24 year.

On 3 August 2024 Kristina withdraws \$100,000 from the revolving credit facility to renovate her rental property. The balance of the revolving credit facility increases from \$370,000 to \$470,000. This work does not qualify for the new build exemption. As this is not private expenditure nor fully deductible no adjustments are needed to Kristina's loan balance.

As the balance of the revolving credit facility is below the high water mark, Kristina is entitled to deduct all of the interest after applying the 75% phasing reduction for the 2024–25 year.

If not for the high water mark approach, Kristina could have achieved a similar outcome by retaining \$100,000 of the inheritance in a separate account and using this to pay for the renovations. This would, however, have resulted in her incurring higher net interest expenditure between 1 April 2023 and 1 April 2024 due to the interest rate charged on the revolving credit facility being higher than the interest rate paid on a savings account.

Further details

- 4.38 Many taxpayers will have more than one loan funding their residential rental property (or properties); for example, a mixture of a fixed term loan and a revolving credit account. The Government considered whether the high water mark proposal could apply on a portfolio basis, but proposes it apply on each loan separately. While a portfolio basis would be needed to have the same

treatment as an equivalent taxpayer with a single loan, the loan by loan basis will still be taxpayer favourable compared with not applying a high water mark and will remove significant complexity. Submissions are sought on whether there are any significant adverse effects that could occur under a loan by loan basis that would not occur with a portfolio basis.

- 4.39 If the person acquired the property in an agreement that met the requirements to be pre-27 March property but settlement and/or the loan draw down were not until after 26 March 2021 the high water mark calculation would be identical except it would be at the date the loan was drawn down to complete settlement rather than 26 March 2021.

Conclusion

- 4.40 This proposal means that where a person has a loan account that funds pre-27 March residential property investment, that account can continue to be used to receive and make payments relating to that investment without creating compliance difficulties or inappropriate deduction denial. The Government expects this would significantly lower compliance costs, remove the disincentive to defer principal repayments and align the treatment of different funding products.

Feedback on high water mark

Questions for submitters:

- Do you agree with the proposed approach to a high water mark?
- Are there some products that can be excluded (for example, loans that only decrease) or should the high water mark apply to all loans?
- Are there any situations when a portfolio basis for a high water mark could be necessary?
- Are there other issues with applying a high water mark that have not been considered above?
- Are there other products that raise issues that are not addressed by the high water mark proposal?

Foreign currency loans

- 4.41 While the majority of lending on New Zealand properties will be in NZD there may be some in foreign currencies.

Pre-27 March residential rental properties

- 4.42 A foreign currency loan to finance a residential rental property in New Zealand would be subject to the financial arrangements rules. These rules cover the NZD equivalent of foreign currency interest as well as any foreign exchange gains and losses on the principal outstanding. There would be significant complexity in designing transitional phasing rules for these loans. Instead, the

Government proposes that any interest on a foreign currency loan that funds a pre-27 March residential rental property would become non-deductible on 1 October 2021 with no phasing period.

- 4.43 However, a loan funding the same property in NZD would be subject to phasing and it is proposed that the refinancing exception, covered above, would allow a foreign currency loan to be refinanced with an NZD loan. Therefore, a foreign currency loan over a residential rental property in New Zealand could be refinanced with an NZD loan to retain interest deductibility subject to phasing. If the refinancing was before 1 October 2021 all interest deductions would be subject to phasing. If the refinancing was after 1 October 2021 there would be a period between 1 October 2021 and the date of the refinancing where no interest would be deductible after which interest would become subject to phasing.

Post-27 March residential rental properties

- 4.44 For properties acquired on or after 27 March 2021 and financed with a foreign currency loan no interest would be deductible. This is consistent with the same property financed with a NZD loan.

Other borrowing

- 4.45 Any foreign currency loans that could be traced to a deductible purpose (for example, properties qualifying for the new build exemption or other business activities) would continue to be deductible under the current rules.

Hedges

- 4.46 A foreign currency loan may be hedged so the New Zealand borrower is not subject to gains and losses from foreign currency movements. These hedging gains and losses are not treated as interest for New Zealand tax purposes.
- 4.47 However, to ensure symmetry, it is proposed that gains and losses on a hedge, to the extent it is a hedge of a foreign currency loan that is covered by the interest limitation proposals, should also be removed from the tax base. This means losses on that portion (or all) of the hedge would not be deductible and gains would not be assessable.
- 4.48 This language is similar to that already applied in the Fair Dividend Rate foreign exchange hedging rules and would apply from when the hedge is entered into (or the proposals apply for existing hedges). It would be a question of fact whether, and to the extent, a hedge was for the foreign currency loan. Taxpayers would not be able to determine this after at the time of taking a tax position as this could result in losses being deducted and gains being non-assessable.

Chapter 5

Disposal of property subject to interest limitation

Introduction

- 5.1 Interest deductions for residential investment property are to be disallowed from 1 October 2021, unless the property qualifies for the development or new build exemption. The reason for this treatment is to reduce a tax advantage for property investment in that full deductions for interest have been allowed, while income from capital gains has often not been taxed. This leaves the following questions for cases where property is sold:
- should a deduction for interest be allowed at the time of sale if the sale is taxable (on revenue account), as in that case all the income from investing in the property is taxed; and
 - is there a case for deducting some interest where the amount of interest incurred exceeds the non-taxable capital gain on sale (that is, where disallowing the interest deduction results in taxing more than actual income from the property even if the property was sold for a non-taxable capital gain)?
- 5.2 There are a number of rules that limit tax benefits for investors and support system integrity. Most important are the rental loss ring-fencing rules and bright-line anti-arbitrage rules. The former “ring-fence” expenditure on loss-making residential investment properties, meaning an investor cannot deduct such expenditure from their other income (for example, salary or wages, or business income) to reduce their tax liability. The latter similarly ensure that any losses from a property sold under the bright-line rules are ringfenced and cannot be offset against income other than gains from the sale of land. Options for the treatment of interest on disposal will have to include consideration of how they interact with these provisions.
- 5.3 This chapter sets out different options for allowing interest deductions on disposal. These options meet housing and tax policy objectives to different degrees while protecting the tax base from selective actions of taxpayers.
- 5.4 Consequently, design details have not been decided and the Government welcomes submissions on the relative merits of the design options proposed. Specific questions in relation to the options are listed at the end of this chapter.

Amount of interest potentially deductible on sale

- 5.5 The interest potentially deductible on sale would only be interest that under existing rules would be deductible (whether in the year incurred or allocated to a subsequent year because of the ringfencing rules). For example, interest attributable to private use of a second home or bach is not deductible now and would not become deductible on sale under this proposal.

Options for treatment of interest when sales are on revenue account (gain is taxable)

Revenue account sales

- 5.6 Land is held on revenue account when it will be taxed on sale. Examples of properties held on revenue account include those purchased with the intention of disposal or acquired for purposes of business relating to land, such as development.
- 5.7 Properties taxed on sale under the bright-line rules are held on revenue account only once it is known that they will be sold within the bright-line period. They are not held on revenue account otherwise.
- 5.8 Residential land that is held on revenue account falls into a number of categories. For example, an amount will be income if derived from disposing of residential land:
- within ten years of acquisition (s CB 6A);
 - that was acquired with an intention or purpose of disposing of it (s CB 6);
 - that was acquired by a person (or someone associated with them) for the purpose of a business of dealing in land, developing land, dividing land into lots, or erecting buildings (s CB 7); or
 - within ten years of its acquisition, if at the time of acquisition the person was (or was associated with someone who was) in the business of dealing in land, or developing or dividing land (ss CB 9 and CB 10); or
 - within ten years of the completion of improvements to the land, if at the time the land was acquired the person was (or was associated with someone who was) in the business of erecting buildings (s CB 11); or
 - that was part of an undertaking or scheme, meeting certain criteria, that involved the development of land or the division of land into lots (ss CB 12 and CB 13); or
 - within ten years of acquisition if it was disposed of for more than the cost of the land and at least 20 percent of the excess arises from one or more of the factors listed. These factors include the removal of a heritage order, a change to the rules, likelihood of consent being granted, and similar (CB 14).
- 5.9 Any rules for the treatment of interest on revenue account sales will apply to property held on revenue account that is not a development or new build (where deductions will continue to be available for interest as incurred). In practice, almost all of the properties held on revenue account for which a deduction for interest on sale may be allowed would be those taxable under sections CB 6A or CB 6 (bright-line or purchase with intention of resale) given that most property held on revenue account because it is used for development would also qualify for the development exemption.

Options for the treatment of revenue account disposals

5.10 Currently, where property is held on revenue account, any rental income is taxable, expenses (including interest) are deductible and any gains or losses at point of sale are taxable or deductible as appropriate. As set out above, bright-line land is not held on revenue account unless and until it is known that it will be sold within the bright-line period.

5.11 Several options for deferring or denying the deductibility of expenses have been explored, along with their associated design issues. Four of these options relate to property held on revenue account. These are:

Option A – Deductions denied

Option B – Deductions allowed at point of sale

Option C – Deductions allowed at point of sale to the extent they do not create a loss

Option D – Anti-arbitrage restriction of interest

Option A – Deductions denied

5.12 Under this option, interest deductions would be permanently denied in all circumstances (subject to those allowed under the developer or new build exemptions).

5.13 Complete denial is simple and would maximise the impact on the housing market by most strongly discouraging investments in residential rental property. Denying these deductions could therefore put the most significant downward pressure on house prices of all the options and increase accessibility for first-time buyers.

5.14 However, permanently denying deductions could raise questions around fairness and coherence. The effective tax rate for residential property investments could be raised above the effective tax rate of other investments. This means that permanent denial of a deduction could lead to taxation that is much higher than full taxation of the total actual income generated by the property investment, and higher than for any other investments. Similarly, this introduces the possibility for scenarios where taxpayers who have lost money overall would be subject to tax. These factors are likely to reduce investor demand overall but could also be viewed as unfair for investors subject to high effective tax rates.

5.15 Although it is very difficult to predict the full impacts of this option, overall, it is likely to be the most favourable one for first-time buyers. It will, however, also lead to the most instances of over-taxation of property investors relative to their income from the property.

5.16 This option is likely to be simpler than the other options which allow interest to be deducted on a deferred basis.

Option B – Deductions allowed and deferred to point of sale

- 5.17 Under this option, interest deductions would be allowed in full at point of sale. Net rental losses are already ringfenced under the existing rental loss ringfencing rules but are generally released when property is sold on revenue account.
- 5.18 Deducting at the time of sale when the gain is taxed ensures an investor's total actual income is taxed (and not overtaxed).
- 5.19 That deductions are deferred means the taxation of residential investment property held on revenue account is increasing relative to the status quo. This will still shift the housing market in favour of first-home buyers, although not as strongly as option A.

Arbitrage issues

- 5.20 By allowing deductions at the time of sale, this option increases the risk of arbitrage. For example, if deferred interest is taxable in the year of sale, there could be an incentive to sell property within the bright-line period. Property could be sold before the bright-line date to create a revenue account loss or held until after the date for a capital account gain.
- 5.21 Options C and D address arbitrage risk and this is also discussed in chapter 12 on Residential loss ringfencing.

Example 17: Option B

Annette buys a house for \$1m. Three years later she sells the house for \$1.2m. The house was used as a residential rental property for the whole period.

Over the three years she incurred \$300k of accumulated interest deductions. In the year of sale, she is able to deduct \$200k against her tax liability arising from the sale of the property. The remaining \$100k can be offset against other income resulting in a net taxable income reduction of \$100k from the combination of the taxable gain and the interest deduction.

If Annette sold the property on capital account, she may not get a deduction for the interest (if option E below applies). This would give her an incentive to sell on revenue account.

- 5.22 This option has slightly higher compliance costs than option A as it requires taxpayers to keep track of deferred interest expense and to deduct it in the year of sale.

Option C – Deductions allowed at point of sale to the extent they do not create a loss

- 5.23 Under this option, deductions would be allowed at point of sale but only to the extent that they do not create a loss. Any interest in excess of this would be non-deductible. This is similar to option B except it addresses arbitrage risk.
- 5.24 It is possible that the loss limitation could be confined to those properties that are most subject to arbitrage risk bright-line property and possibly property on

revenue account under section CB 6 (intention test). For other revenue account property, the sale could release all of the deferred interest as discussed in option B.

Example 18: Option C

Assume Annette buys and sells a house as she did above (in example 17), accumulating the same amount in interest deductions. Under this option, her interest deductions are limited to \$200k. So overall, she is not taxed on the disposal, but she does not get a net deduction of \$100k as she does in Option B.

The remaining \$100k of interest expense cannot be deducted and is forfeited.

- 5.25 This option is likely to have similar levels of compliance and administrative costs as option B.

Option D – Anti-arbitrage restriction for interest

- 5.26 Under this option, interest would be deductible at the time of sale subject to restrictions. Rather than simply denying the interest deduction to the extent it exceeds the gain on disposal, it would be taken into account in section EL 20 as if it were part of the cost of the property. This would incorporate the current bright-line anti-arbitrage rule that would allow the excess interest to potentially be deductible against other income from revenue account property derived in the same or a later income year.

- 5.27 Another option to achieve a similar anti-arbitrage outcome would be to modify the residential rental loss ringfencing rules to incorporate it. This is described in chapter 12 on the residential loss ringfencing rules.

Example 19: Option D

Under this option, Annette would not have \$100k permanently forfeited as in the previous example. Instead, the excess interest would be ringfenced and so could be offset against other real property gains under section EL 20.

Options for treatment of interest when sales are on capital account (gain is non-taxable)

- 5.28 The following paragraphs outline options for deductions for interest in the case of property sold on capital account. In all cases, interest deductions should not be allowed to the extent of any untaxed gain. This is the clearest case where the tax system is not fully taxing investment in residential property. Option F considers the case to allow a deduction of interest in excess of the untaxed gain.

Option E – No deductions allowed

Option F – No deductions allowed up to amount of non-taxed gain with the excess deductible, potentially subject to anti-arbitrage rules.

Option E – No deductions allowed

- 5.29 Under this option no deductions would be allowed, as a rough offset for the benefit of capital gains not being taxed. All interest deductions associated with the property would be forfeited. This has the strongest impact on reducing investor demand for residential property. It has the potential to produce a high tax rate on the property, but this is mitigated by the fact that the capital gain is not taxed. Overall, the property owner could be taxed on more or less than their actual income.

Option F – No deductions allowed up to amount of non-taxed gain with the excess deductible

- 5.30 Under this option, interest could not be deducted to the extent of any untaxed gain. This amount of interest is forfeited. Deductions in excess of a non-taxable gain can be deducted.
- 5.31 In the case where deferred interest deductions are less than the non-taxable capital gains, all interest deductions would be forfeited. This is because overall, the taxpayer is still paying tax on less than their actual income from investing in the property. The denied interest deductions will reduce the tax benefit from investing in the property but not completely eliminate it.

Example 20: Option F – interest less than the untaxed gain

Reuel sells his residential rental property for an untaxed gain of \$200k, but \$150k of interest has been disallowed during the period the property was rented. Under the current tax rules, Reuel would be taxed on income from the property that is \$200k less than his actual income.

Under option F, because his deferred interest deduction (\$150k) is less than his untaxed capital gain (\$200k), all his interest deductions are disallowed and forfeited. This means his taxable income is \$50k less than his actual income (compared to \$200k under current law).

- 5.32 In the case where deferred interest deductions are more than the non-taxable capital gains, interest deduction up to the amount of the untaxed capital gain would be forfeited. The amount of interest in excess of this amount would be deductible. This would have the same effect as if all income from the investment were taxable (including capital gains) and expenses were deductible.

Example 21: Option F – interest more than the untaxed gain

Reuel sells his residential rental property for an untaxed gain of \$200k, but \$250k of interest has been disallowed during the period the property was rented. Under the current tax rules, Reuel would be taxed on income from the property that is \$200k less than his economic income.

Under option F the amount of interest up to the untaxed gain (\$200k) would be permanently disallowed.

The \$50k of excess interest would be deductible. This is the same result as if all of the \$200k gains were taxable, and all of the \$250k interest expense were deductible. In this case, all of Reuel's actual income from the investment would be taxed.

- 5.33 This option does introduce risks of arbitrage relative to the ringfencing of losses from revenue account sales described in Option D. This would require similar anti-arbitrage measures. These measures could be achieved through loss ringfencing or modifying the current bright-line anti-arbitrage provision.

Relationship between options for property held on revenue or capital account

- 5.34 The options proposed above represent various degrees of deduction denial. It is important to ensure how interest is treated for both revenue account and capital account properties is consistent and ensuring that any restrictions or anti-arbitrage restrictions are also matched.
- 5.35 One approach would be that even if some interest on revenue account property is deductible, no interest would be deductible on a capital account sale. This has simplicity advantages while being a rough offset for the non-taxation of capital gains.
- 5.36 If a more targeted approach were considered, then options A and C should be considered as potential matches for option E, as none of these options allow excess interest (the amount that exceeds a gain on sale) to be deducted. Option B would be a potential match for option F without anti-arbitrage, as they both potentially allow all interest in excess of non-taxable gain to be deducted. Option D could be matched with option F with anti-arbitrage, as both would potentially allow a deduction of interest in excess of non-taxable gain but subject to some restrictions. A table summarising the key impacts of these options is at the end of this chapter.

Implementing anti-arbitrage provisions

- 5.37 Option D incorporates anti-arbitrage provisions, and option F could also incorporate anti-arbitrage provisions. These are important for the Government to discourage the selective sale of residential property to minimise taxable gains and maximise deductible losses, including the deduction for deferred interest expense. This raises conceptual issues (is this a residential rental loss or a capital loss) and mechanical issues for the best way to address it.
- 5.38 There is an anti-arbitrage provision in the Act to address arbitrage on the sale of bright-line property by ringfencing the bright-line revenue account loss so it can only be used to offset other real property gains (section EL 20). This could be extended to property sold for a loss on revenue account under section CB 6 (purchased with the intention of resale) as it is difficult to determine a taxpayer's intention. We seek feedback on whether such a provision is desirable or necessary.
- 5.39 One possibility to apply anti-arbitrage principles to the deferred interest deduction would be to effectively treat the deferred interest as part of the cost of acquisition. In that case, the interest could only be deducted against gains on the sale of property. The restriction would apply to deductible interest

related to revenue account properties, and any interest that is deductible for capital account properties.

- 5.40 Mechanically, this approach could be adopted by amending the bright-line anti-arbitrage rule (section EL 20) to treat the interest deductible on sale as if it were part of the cost of the property. If this means there is a net loss on sale, that provision would restrict the deduction only to offset other real property gains in the same or a later income year. If it is a capital account sale and option F is adopted, the potentially deductible interest could be treated as if it were a revenue account loss on sale of bright-line property under section EL 20, and so the excess interest could only be deducted against taxable gains from the sale of real property. Interest would then not be taken into account for residential rental loss ringfencing.
- 5.41 Another approach would be to modify the residential loss ring-fencing rules to incorporate anti-arbitrage provisions. In this approach, the separate bright-line anti-arbitrage provision (section EL 20) could be repealed. Instead, a loss on disposal of residential rental property would be treated as a rental loss and be subject to potential deferral of deduction under those provisions. Taxable gains on the sale of residential rental property are already treated as residential rental income, so deductible losses (including the interest component) could be offset against taxable gains and net rental income.
- 5.42 Chapter 12 on interaction with the residential rental loss ringfencing regime provides additional discussion on how these different disposal options could be incorporated.
- 5.43 The Government would like to hear from submitters on how different approaches to allowing some interest to be deducted (or no interest to be deducted) on the sale of residential investment property might or might not achieve the Government's policy objectives.

Questions for submitters

Below are questions the Government is posing to help focus discussion, though comments on all aspects of these proposals are welcome:

- Which option for the treatment of interest on sales of revenue account property best balances housing market incentives, efficient and fair taxation, and protection of the tax base against arbitrage risk?
- Should the bright-line anti-arbitrage provision be extended to sales taxable under section CB 6 (purchased with the intention of resale)?
- Should some interest deductions be allowed when property is sold on capital account?
- What are the trade-offs in considering housing market objectives and tax policy efficiency and equity objectives?
- How could anti-arbitrage provisions be incorporated? Do you have any preferences between amending the bright-line anti-arbitrage rule to incorporate interest, or the residential rental loss ringfencing rules to incorporate a revenue account loss? Do you have another approach to suggest?

Table 2: Summary of option key impacts

Revenue Account Property Options	Impact on housing market	Degree of taxation	Compliance costs, complexity	Fiscal Impact
Option A – Deductions denied	This option would have the greatest impact on the housing market by offering the greatest disincentive to property investment of the options provided. This will likely shift the market in favour of first-time buyers.	This option would introduce the highest degree of over taxation for investors by allowing instances where individuals are taxed on losses. Overall, this option represents a significant increase in the amount of taxation compared to the status quo.	This is a very simple option and therefore the compliance costs are low.	This option is likely to have the highest tax effect as no deductions are permitted.
Option B – Deductions allowed but deferred to time of sale	As deductions are deferred, this represents a disincentive to property investment compared to the status quo, only to a much lesser degree than option A. This will still likely shift the market in favour of first-time buyers.	This option would come closest to taxing economic income. This still represents an increase in taxation compared to the status quo due to the deferral of the interest deduction.	The compliance costs for this option are low but slightly higher than option A. Taxpayers must keep track of their incurred interest expense in order to deduct in year of sale.	This option will have a low tax effect due to the interest deduction being claimed on sale.
Option C – Deductions allowed at time of sale to the extent	As deductions are both deferred and limited under this option, this represents a greater	The chance that tax will be payable on a net loss is lessened	Similar to option B and D.	Tax effect is less than option A but higher than option B.

Revenue Account Property Options	Impact on housing market	Degree of taxation	Compliance costs, complexity	Fiscal Impact
they do not create a loss	disincentive to property investment than option B, but not to the extent of option A. Consequently, the shift in favour of first-time buyers is likely to be similar to that seen in options A and B.	compared to option A.		
Option D – Deductions allowed at time of sale with anti-arbitrage provisions	This option is an alternative approach to achieving a similar outcome as seen in option C. It is more generous than option C, but the impacts should be broadly similar.	As above.	Higher compliance cost than the others due to the additional requirements of anti-arbitrage.	Broadly similar to C but slightly smaller tax effect

Capital Account Property Options	Impact on property market	Degree of taxation	Compliance costs, complexity	Fiscal Impact
Option E – No deductions allowed	Similar to option A compared to status quo.	More taxation than option F as no interest would be deductible.	Lower impact on compliance costs than Option F.	Greater tax effect than Option F.
Option F – No deductions allowed up to amount of non-taxed gain with the excess deductible	Less impact on the property market than Option E, but still potentially significant compared to the	More generous than Option E.	Similar to options D given the complexity of potentially incorporating	Smaller tax effect than Option E.

Capital Account Property Options	Impact on property market	Degree of taxation	Compliance costs, complexity	Fiscal Impact
	status quo where all interest is deductible even when property is sold on capital account.		anti-arbitrage rules.	
Option E – No deductions allowed	Similar to option A compared to status quo.	More taxation than option F as no interest would be deductible.		

Chapter 6

Development and related activities

Government decision on a development exemption

- 6.1 The Government has agreed in principle that property developers should be provided an exemption from the interest limitation rules. This chapter will consider the scope of the development exemption and the definition of “development.”
- 6.2 Unless explicitly stated, qualifying for the development exemption from interest limitation does not override or change other provisions which relate to the allowance of deductions for interest. For example, if someone incurs interest to build a house to live in, that would qualify for the development exemption as proposed, but the interest would nevertheless not be deductible due to the private limitation.²⁴

Design of the exemption

- 6.3 The exemption should be wide enough in scope to encompass development activity which may result in the construction of a new build (as defined in chapter 7). For certainty and simplicity, the exemption should be largely based on existing tax concepts and provisions relating to property development.
- 6.4 If a development meets the requirements of the exemption, the exemption will apply whether or not the person holds their property on revenue account (taxable on sale).
- 6.5 This exemption will apply on a property basis, rather than on a taxpayer basis. Applying the exemption on a property basis allows it to apply to one-off developments as well as developments undertaken as part of a business of developing property.

Qualifying development

- 6.6 Development should include activity which results in a new dwelling that qualifies as a “new build,” consistent with the definition provided in chapter 7. However, development may also be broader than activity that results in a new build. It could include, for example, development which extends the life of a building for the purpose of its continued use (rental) by an investor. This is discussed later under remediation work.

²⁴ The private limitation provides that deductions for expenses are not allowed if they are for private or personal activities and not for earning taxable income. For example, interest incurred on a debt to purchase a home to live in is not deductible as the debt was used to purchase a house used for private purposes.

- 6.7 The intention is that development for these purposes will include making improvements to land which contribute to increasing housing supply. This will include improvements to land, erecting a building or otherwise, that contribute to the creation of a new build.
- 6.8 The Government proposes to define the activity qualifying for the development exemption based on current terminology in the land sale provisions of the Income Tax Act 2007. This will be broader than what is encompassed by the term “development” in the land sale rules (for example, including erecting buildings).
- 6.9 The exemption is intended to cover:
- land being developed by persons in the business of developing or dealing land or erecting buildings (captured under section CB 7 of the Income Tax Act 2007), and
 - other developments which may not be covered under section CB 7 but contribute to the creation of a new build. For example, persons undertaking a one-off development or developing properties to rent out themselves (if they are not already in the business of developing or dealing in land or erecting buildings).

Statutory provisions relating to development - section CB 7

- 6.10 Section CB 7 provides that land acquired for use by taxpayers as part of certain land-related businesses is held on revenue account. These businesses are:
- Dealing in land;
 - Subdividing and developing land; and
 - Erecting buildings.
- 6.11 It is anticipated that almost everyone who develops residential property will hold the property on revenue account under section CB 7 because they are in one of the above businesses. This will account for almost all developments of residential property. We therefore propose that residential investment property that is held on revenue account under section CB 7 should qualify for the development exemption.

Other developments

- 6.12 Although most property developments will be covered by the exemption for property held in section CB 7 businesses, there may be other development activity which creates a new build on land that is not within that exemption.

- 6.13 The exemption should also capture other developments such as:
- one-off developments by people not in the business of developing property; and
 - property development on land not captured by section CB 7 (for example, because the land was not acquired for the purpose of a development business but was nevertheless developed).

- 6.14 Persons who undertake this type of development activity may not necessarily consider themselves to be “property developers”, however, their activity will still result in an increase to New Zealand’s housing stock. For this reason, they should be able to claim the development exemption.

Example 22 – development that is not on revenue account under section CB 7

Aroha buys an empty piece of land to build a house for her whānau. Since it is a large section, she decides to build a second house to rent out. Aroha is not in the business of developing land, so she would not qualify for the exemption for property held in CB 7 businesses. However, her building activity would mean the property qualifies for the development exemption – she has engaged in development activity which has created a new dwelling. Aroha’s property will qualify for the development exemption²⁵ while the development is taking place and may later transition to the new build exemption.

- 6.15 We propose that for this type of one-off development, the exemption will apply where:
- there is interest on debt relating to residential investment property;
 - the debt is used for subdivision, development, or erecting a building; and
 - the activity is carried out for the purpose of creating one or more new builds.
- 6.16 Other requirements for obtaining an interest deduction, such as incurring the interest in order to derive taxable income, will still need to be met to claim the deduction.
- 6.17 Examples of developments that may qualify (activities related to creating a new build) include:
- building a house;
 - converting a single house into multiple flats;
 - converting a commercial or industrial property to a residential property; and
 - relocating a house;

²⁵ Aroha must still meet the other requirements to obtain a tax deduction for the interest, such as incurring the interest to derive assessable income. Whether these tests are met will depend on the facts of each situation.

to the extent that the activity is subdivision or development of land or erecting a building.

Remediation

- 6.18 Remediation work is a grey area where it may be difficult to draw a well-defined boundary on whether it is a development. However, there are grounds for regarding some remediation work as adding to housing supply in the long-term.
- 6.19 Taxpayers who carry out remediation work professionally as a part of development activity (that is, they buy properties, renovate them, and then sell them) will generally be captured under section CB 7 and will be included in the exemption.
- 6.20 It may not be appropriate for a property owner who engages in some one-off renovations of a property that are not substantial (such as renovations of a kitchen or bathroom) to get the development exemption, because even though the renovations may make the dwelling more attractive, they do not add to housing supply. On the other hand, remediation can be part of structural improvements (such as, earthquake strengthening and weather tightening) that allow the housing structure to be viable longer than it otherwise would. This kind of remediation adds to housing supply in the longer term and should obtain the development exemption.
- 6.21 One option would be to only include remediation work as “development” where the work makes a building habitable or extends the life of a building. It would also include work to convert a building from non-residential use (such as a commercial building) into a residential building.
- 6.22 Remediation may be particularly important to extend the life of some buildings that are not suitable for demolition or where demolition is restricted, such as for heritage buildings.
- 6.23 If the development exemption is extended to include remediation work, the exemption will only be available for interest on debt used to fund costs that have been or will be capitalised, not where the costs are deductible as incurred.
- 6.24 The Government seeks submissions on whether remediation work should be included in the exemption, and if so, how this would work. How would remediation that qualifies for the exemption be defined? Should any special criteria apply for buildings that have restrictions on demolition, such as heritage buildings?

Timing

- 6.25 The Government also seeks submissions on when the development exemption should begin. When property is acquired with an intention develop it (for example, land held on revenue account under section CB 7), it would generally be from the time of acquisition of the property. What about properties not

acquired with that intention, but where that intention is formed later? Current provisions applicable when a property is converted from a personal use to a taxable use may be relevant, for example, when substantial work is commenced. The Government seek submissions on this.

- 6.26 The exemption would apply while the property is being developed until the earlier of when the property is sold (settlement date) or until the CCC for a new build is issued. If the property is being held for rental or sale after the CCC is issued, the developer may qualify for the new build exemption from the time the CCC is issued until the property is sold. In the case of remediation of a building for which no new CCC is issued, the exemption would apply until the remediation work is complete. This supports cashflow during the build but prevents overextending the exemption.

Amount of interest qualifying for development exemption

- 6.27 Where property is acquired for a land business (taxable under CB 7) and developed, the exemption should apply for interest related to the acquisition cost, with that interest being deductible immediately.
- 6.28 Where property is not acquired for the purpose of a land business (for example, it is not on revenue account) but an intent to develop the land is formed sometime after the acquisition, the exemption will apply to the interest on additional debt acquired for the development activity. This approach will apply for debt used to fund qualifying remediation work. In addition to interest on debt to fund the development, interest may be deducted on debt used to acquire the property from the time the development activity is started. How to determine the commencement date and how to apportion if only a portion of the land is being developed would be determined under current practice.

Relationship with new build exemption

- 6.29 In many cases the property resulting from a development benefiting from the development exemption will constitute a new build and will therefore qualify for the new build exemption when sold to an investor or the code compliance certificate (CCC) is issued. How these exemptions relate to each other is discussed in chapter 7 (refer to paragraphs 7.9 to 7.11) and chapter 8 (refer to paragraph 8.12).
- 6.30 The Government seeks submissions on how the development exemption should work and whether our framing has appropriately captured relevant types of development.

Questions for submitters

Comments on all aspects of the proposals are welcomed. Below are several questions officials would specifically like to seek feedback on from submitters:

- Are there other types of developments or activity which should be covered under this exemption?
- Should land dealers (who are included under section CB 7) be carved out from the proposed section CB 7 safe harbour?
- Do you agree with the proposed criteria for the development exemption to apply?
- Should remediation work be included? If so, what types of remediation work should be included? If some remediation work is included, how would this relate to the new build exemption? How does partially including remediation work impact heritage buildings?
- When should interest begin to be deductible when property is not acquired for the purpose of development, but that intention is formed later?
- What is the amount of interest on debt that should qualify for the exemption when property was not acquired for the purpose of development, but development activity commenced some time later?

Chapter 7

Definition of new build

What does this chapter cover?

- 7.1 The Government proposes that owners of new builds will have:
- a five-year bright-line test (“new build bright-line test”); and
 - an exemption from the proposed interest limitation rules.
- 7.2 This chapter sets out a proposed definition of a “new build”. The Government invites your views on how a new build should be defined to best achieve the objective for the new build rules, which is to maintain new housing supply notwithstanding the extended ten-year bright-line test and the proposed interest limitation rule.

Definition of new build

- 7.3 The Government considers property should only qualify as a new build where residential housing supply has clearly increased. This will occur where a self-contained dwelling (with its own kitchen and bathroom) has been added to residential land and the dwelling has received a code compliance certificate (“CCC”). However, this must be balanced with the need for simple and accessible rules that can be easily understood and complied with by taxpayers, and readily administered by Inland Revenue.
- 7.4 Throughout this discussion document three new build categories are used: simple new builds, complex new builds, and commercial-residential conversions. Each category is considered in more detail below.

Simple new builds

- 7.5 Simple new builds involve adding one or more self-contained dwellings to bare residential land. This includes:
- **Adding a dwelling to bare land.** This is where one or more dwellings are added to bare residential land. It does not matter whether a new build is fully or partially constructed on-site, so it can include a modular home, and would include a dwelling that has been relocated onto the land.²⁶
 - **Replacing an existing dwelling with one or more dwellings.** This is where an existing dwelling is removed or demolished and is replaced with one or more dwellings. It is proposed that one-for-one replacements would qualify even though there is no increase in housing supply,

²⁶ While relocated dwellings are existing buildings, most of these dwellings would likely be demolished if they were not relocated and installed on new sites. Dwellings are regularly relocated off a site to allow for land to be developed. Installing and making any necessary improvements to relocated dwellings is also likely to require fewer building materials than constructing completely new dwellings. By adding a relocated dwelling to land, housing supply is increased.

because it may be administratively difficult to distinguish between cases where an existing dwelling is replaced with multiple new dwellings and where a new dwelling is replacing an existing dwelling one-for-one. A CCC for a new dwelling may not show what was on the land before the new dwelling was added but may instead just show that a new dwelling has been added to the land. In most cases it is also expected that where an existing dwelling is replaced, it will be replaced with multiple new dwellings.

Complex new builds

7.6 Complex new builds involve adding one or more self-contained dwellings to residential land that already has an existing dwelling on it, without separate title being issued for the new build portion of the land.²⁷ This includes:

- **Adding a standalone dwelling.** This is where a dwelling is added to residential land without making any changes to the existing dwelling. For example, adding a dwelling to an existing dwelling’s front or backyard.
- **Attaching a new dwelling to an existing dwelling.** For example, where a dwelling is added on top of, underneath, or next to an existing dwelling on residential land.
- **Splitting an existing dwelling into multiple dwellings.** This is where residential land has an existing dwelling on it that is converted into multiple self-contained dwellings. For example, where a six-bedroom house is converted into three two-bedroom units. While conversions utilise existing buildings, they add to housing supply by enabling multiple households to occupy a space that previously only accommodated one household. Significant renovations may be required as part of conversions, including adding in new kitchens and bathrooms, as well as firewalls between the dwellings.

7.7 These new builds are considered complex because the presence of an existing dwelling on the land means apportionment is likely to be required for both the new build exemption from interest limitation and the new build bright-line test (refer to paragraphs 8.27 to 8.29 and paragraphs 9.10 to 9.13 for more information).

Commercial to residential conversions

7.8 This new build category covers the conversion of commercial buildings into self-contained dwellings. An example is an office building that is converted into apartments, or a large commercial heritage building such as a harbour warehouse that is converted into townhouses. While conversions make use of existing buildings, including them in the definition of a new build supports the Government’s objective of increasing housing supply, and should be administratively simple to verify. It may also be faster to convert commercial

²⁷ It is proposed that where land is subdivided and a new build is added to the subdivided section, the subdivided section with the new build on it would be considered a new build (and would fall within the “adding a new dwelling to bare land” category mentioned in paragraph 7.5 above. Apportionment may be required in these cases. Refer to paragraphs 8.27 to 8.29 as well as paragraphs 9.10 to 9.13 for more information.

property into dwellings than it is to build brand new dwellings, and should require the use of fewer building materials.

Renovations that do not clearly increase housing supply excluded

- 7.9 The Government proposes that renovations to existing dwellings that do not result in an additional dwelling on the land would not be eligible for the new build rules. For example, adding a new room to an existing dwelling, or improving the quality of an existing dwelling by modernising an outdated kitchen or bathroom, would not be eligible. These sorts of renovations do not clearly increase housing stock, and it could be hard to distinguish between substantial and minor renovations. Some remediation work done to existing dwellings may be eligible under the development exemption – refer to paragraphs 6.18 to 6.24 for more information.
- 7.10 In principle, renovating an uninhabitable dwelling so that it becomes habitable seems similar to replacing an existing dwelling with a new dwelling, especially if the dwelling is brought up to the standard of a new build. However, differentiating between this and other renovations is likely to be difficult so the Government proposes that these properties would not be considered new builds. The Government invites your views on this issue and is particularly interested in whether there are any tools that could be used to verify that a once uninhabitable house has been renovated so that it becomes habitable. If a significantly renovated (formerly uninhabitable) dwelling were to be eligible for the new build exemption, any overlap with or transition from the development exemption would need to be considered further (to the extent any remediation work done to the dwelling would also be eligible for the development exemption).

Impact of eligibility for the development exemption on definition of new build

- 7.11 New builds may also potentially be eligible for the development exemption while they are being constructed or added to the land. Whether property is eligible for the development exemption does not affect whether that property is later considered a new build. For more information on the development exemption, refer to chapter 6. The transition from the development exemption to the new build exemption for the proposed new interest limitation rules is specifically considered in paragraph 8.12.

Questions for submitters

Comments on all aspects of the proposals are welcomed. Below are several questions that the Government would specifically like to seek feedback on from submitters:

- What do you think of the proposed definition of new build?
- Are there any issues that you think the Government should consider in relation to the definition of new build and:
 - papakāinga housing?
 - heritage buildings?
- Is there some tool that could be used to identify when a dwelling that is completely uninhabitable has been improved significantly, such that it has added to housing supply?

Chapter 8

New build exemption from interest limitation

What does this chapter cover?

- 8.1 This chapter considers the design of the new build exemption from the proposed interest limitation rule. In this chapter, “new build exemption” specifically refers to the exemption from the interest limitation rule for new builds.
- 8.2 The main issues in this chapter that the Government would like your views on are who the new build exemption should apply to (only the early owner of a new build, or also subsequent purchasers) and for how long. The Government’s proposed definition of new build is covered separately in chapter 7.
- 8.3 The Government is not consulting on whether there should be a new build exemption from the proposed interest limitation rule – this has already been decided.

What is the new build exemption?

- 8.4 The new build exemption is an exemption from the proposed interest limitation rule. If the exemption applies, then the interest limitation rule does not apply. This means interest that would have been deductible absent the interest limitation rule will continue to be deductible for debt relating to new builds. This includes interest on borrowings to acquire residential land that a new build is on, to construct a new build, or to fund other expenses relating to a new build such as maintenance, rates, or insurance. The new build exemption will not allow interest deductions that are not available under current law (for example, a taxpayer acquiring a new build to live in will still be denied interest deductions under the private limitation²⁸).
- 8.5 The new build exemption applies to new builds as defined in chapter 7. This includes simple new builds, complex new builds, and commercial to residential conversions. For complex new builds (where land has both a new build and a non-new build on it), only interest relating to the new build is eligible for the new build exemption (refer to the section on apportionment from paragraphs 8.27 to 8.29 for more information).

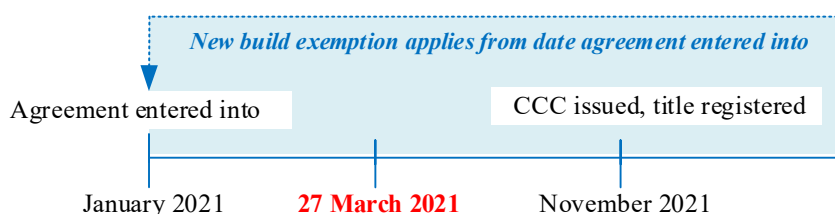
²⁸ The private limitation in section DA 2(2) denies deductions for expenditure or loss that is of a private or domestic nature.

General rule: only new builds with a CCC issued on or after 27 March 2021 eligible

- 8.6 The Government proposes that whether the new build exemption applies to residential land will generally depend on when a new build is added to the land. If a new build receives its code compliance certificate (“CCC”), indicating that a new dwelling has been added to the land, on or after 27 March 2021 then the new build exemption applies to an early owner (and potentially also subsequent purchasers, depending on what the Government decides – refer to paragraphs 8.9 to 8.21) of the land.

Example 23: New build with CCC issued on or after 27 March 2021

Will enters into an agreement to acquire a residential investment property off the plans in January 2021. In November 2021 the new build receives its CCC, and title for the property is registered to Will at this time.



Will may use the new build exemption to deduct interest incurred in relation to the property from the date he enters into the agreement* (provided the interest is deductible under existing tax rules). Will qualifies for the exemption because the new build’s CCC is issued on or after 27 March 2021.

**For more information on when it is proposed the exemption would apply to allow interest deductions from, refer to paragraphs 8.11 and 8.12.*

- 8.7 This chapter uses the term “early owner” to refer to a person who acquires a new build or has added a new build to their land in the circumstances described in paragraph 8.10. It does not matter whether the land is acquired before, on, or after 27 March 2021. Nor does it matter when construction begins, provided the new build’s CCC is issued on or after 27 March 2021. How an early owner and subsequent purchaser could be defined is considered in more detail from paragraph 8.9.

Transitional rule: exception for certain new builds with a CCC issued before 27 March 2021

- 8.8 The Government has decided that a transitional rule will apply for certain new builds acquired on or after 27 March 2021 that received their CCCs before 27 March 2021. For these new builds, the new build exemption will apply to an early owner provided the new build is acquired on or after 27 March 2021 and no later than 12 months after it received its CCC. See paragraph 8.14 for more information on this.

Early owners and subsequent purchasers

8.9 The Government invites your views on whether the new build exemption should apply to early owners of new builds only, or if the exemption should also apply to subsequent purchasers. Proposed definitions for early owners and subsequent purchasers, as well as how the exemption could apply depending on the type of new build, are considered further below.

Early owners

8.10 The Government proposes that the exemption would apply to early owners of new builds. For the purposes of this discussion document, an early owner is a person who:

- acquires a new build off the plans (before a CCC is issued for the new build);
- acquires an already constructed new build no later than 12 months after the new build's CCC is issued;²⁹
- adds a new build to bare land;
- adds a complex new build to land; or
- completes a commercial-residential conversion.

When would the exemption apply from?

8.11 As set out in chapter 7, the Government proposes that a new build would be defined to include simple new builds, complex new builds, and commercial to residential conversions. Table 3 sets out when the new build exemption would apply from for early owners,³⁰ depending on the type of new build.

8.12 The table also provides a high-level overview of whether, and to whom, the development exemption applies. The development exemption applies up until the date a CCC is issued for a new build. If a developer retains a new build for a period after CCC is issued, it is proposed that the new build exemption would apply to the developer up until settlement of the property. The development exemption may apply to the developer concurrently with the new build exemption applying for the purchaser of the new build. For more detailed information on how the development exemption applies, refer to chapter 6.

²⁹ The rationale for allowing anyone who acquires a new build within 12 months of its CCC being issued to be an "early owner" is to ensure the first genuine investor is able to benefit from the new build bright-line test. A new build may change hands a number of times before it is finally acquired by a person as a long-term investment property.

³⁰ Note that the table is only relevant for early owners. For subsequent purchasers (if the Government decides subsequent purchasers are eligible for the exemption), the new build exemption would apply from the date the subsequent purchaser acquires the land.

Table 3

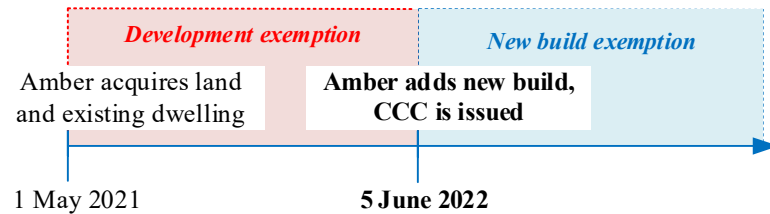
Type of new build	Development exemption applies to:	New build exemption applies to:
<i>Simple new builds</i>		
Sale of completed new build	The person who added the new build to the land, until the date the new build's CCC is issued. If the CCC is issued before the property is disposed of (settlement date), the developer will also be entitled to the new build exemption from the date the new build's CCC is issued until the date of settlement.	The person who acquires the completed new build, from the date of acquisition (a CCC will have been issued before acquisition for these new builds). ³¹
Off the plans acquisitions	The person who adds the new build to the land. Can apply at the same time as the new build exemption applies to the off the plans purchaser. Development exemption ends on the date the new build's CCC is issued.	The off the plans purchaser, from the date of acquisition.
Adding new builds to bare land (excludes off the plans acquisitions), not for immediate sale	The person while they are adding the new build to the land. Development exemption ends on the date the new build's CCC is issued.	The person who adds the new build to the land, from the date a CCC is issued for the new build.
<i>Complex new builds</i>		
All complex new builds (where there is a new build and an existing non-new build on the same title), not for immediate sale ³²	The person while they are adding the new build to the land, until the date the new build's CCC is issued.	The person who adds the new build to the land, from the date a CCC is issued for the new build. Apportionment rules may apply if interest incurred relates to both the new build and non-new build on the land.
<i>Commercial to residential conversions</i>		
Commercial buildings converted into dwellings	The person converting the commercial buildings into dwellings, until the date a CCC is issued for the dwellings.	The person who converted the dwellings, from the date a CCC is issued for the newly converted dwellings.

³¹ This would allow a person who has taken out a loan in order to fund their deposit to claim interest deductions (provided there is sufficient nexus with an income earning activity, in accordance with existing tax principles regarding interest deductions).

³² This includes adding a standalone dwelling on land with an existing dwelling; attaching a dwelling to an existing dwelling; and splitting an existing dwelling into multiple dwellings.

Example 24: Early owner of complex new build

Amber acquires residential land from Will on 1 May 2021 for \$1m. The land has an existing (non-new build) dwelling on it. After acquiring the land, Amber adds a new build to the section. The new build receives its CCC on 5 June 2022.



The new build exemption applies from the date the CCC for the new build is issued, and allows Amber to deduct interest on or after 5 June 2022 on loans for:

- the cost of adding the new build to the land;
- the portion of the \$1m purchase price for the land that is attributable to the new build; and
- other expenses relating to the property, to the extent they are attributable to the new build (for more information on apportionment, refer to paragraphs 8.27 to 8.29).

The development exemption applies to Amber before the CCC is issued, because she is adding a new build to the land. For more information on the development exemption and how it would apply to taxpayers like Amber, please refer to chapter 6.

When would the exemption expire?

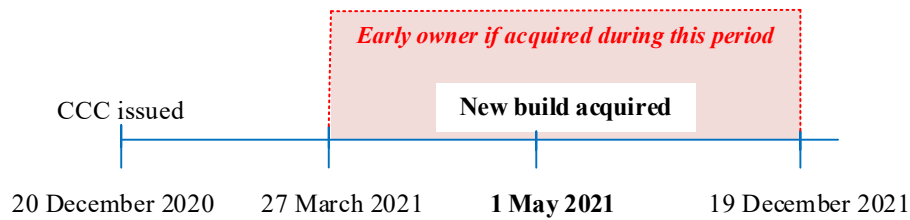
- 8.13 How long the exemption would apply to early owners has not been decided and is considered further from paragraph 8.20.

Transitional rule for new builds with CCCs issued before 27 March 2021

- 8.14 As mentioned above, the Government has decided that the exemption will also apply to new builds that received their CCCs before 27 March 2021 in certain circumstances. This transitional rule applies to a person who acquires land with such a new build on it, provided they acquire the land on or after 27 March 2021, and no later than 12 months after the CCC is issued.

Example 25: Transitional rule for early owners

Xavier acquires residential land on 1 May 2021. The residential land has a new build on it, which received its CCC on 20 December 2020.



Since Xavier has acquired the land no later than 12 months after the new build received its CCC, Xavier is considered an early owner of the new build. The new build exemption applies to enable Xavier to deduct interest he incurs in relation to the land. It does not matter that the new build received its CCC before 27 March 2021.

Subsequent purchasers

- 8.15 The Government is consulting on whether the exemption should be available to subsequent purchasers.
- 8.16 If the new build exemption were to apply to subsequent purchasers, a subsequent purchaser would generally be defined as a person who acquires a new build more than 12 months after a CCC for the new build is issued.

When would the exemption apply from?

- 8.17 Interest would be deductible from the date a subsequent purchaser acquires residential land with a new build on it and would continue to be deductible until the new build exemption expires.

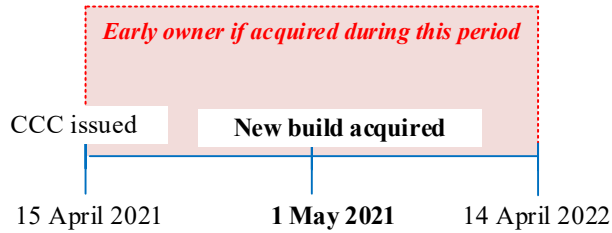
When would the exemption expire?

- 8.18 If the exemption is available for subsequent purchasers, the Government proposes it would only be available for a fixed period, for example for ten or 20 years from the date a new build's CCC is issued. How long the exemption would apply to subsequent purchasers for has not been decided and is considered further below.

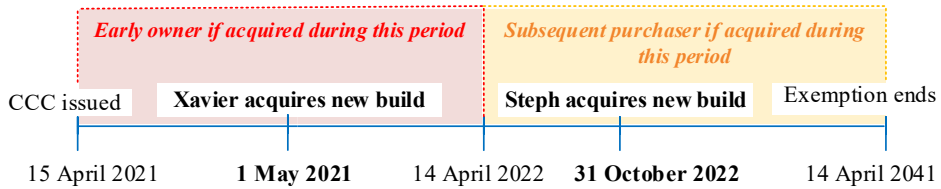
Example 26: Subsequent purchaser

This example assumes the new build exemption applies to subsequent purchasers of a new build for a fixed period of 20 years from the date a CCC for the new build is issued. The period the new build exemption could apply to subsequent purchasers for is discussed from paragraph 8.20.

Xavier acquires residential land on 1 May 2021. The residential land has a new build on it which received its CCC on 15 April 2021. Since Xavier has acquired the land no later than 12 months after the new build received its CCC, the new build exemption applies to enable Xavier (as an early owner of the new build) to deduct interest he incurs in relation to the land.



Xavier sells the land on 31 October 2022 to Steph.



The new build exemption applies to Steph as a subsequent purchaser because Steph acquired the land more than 12 months after the new build on the land received its CCC, within 20 years of the CCC being issued, and the CCC was issued on or after 27 March 2021. The exemption applies to allow Steph to deduct interest until 14 April 2041 (which is 20 years after a CCC was issued for the new build).

No transitional rule for new builds with CCCs before 27 March 2021

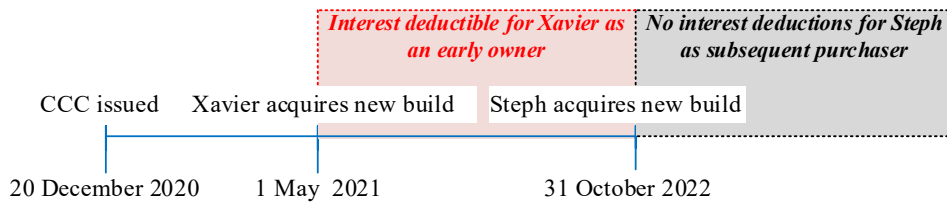
8.19 If the exemption were to apply to subsequent purchasers, the Government proposes the exemption for subsequent purchasers would only apply for new builds that receive their CCCs on or after 27 March 2021. This means the exemption would not apply to subsequent purchasers of new builds that received their CCCs before 27 March 2021.

Example 27: No transitional rule for subsequent purchasers

Xavier acquires residential land on 1 May 2021. The residential land has a new build on it, which received its CCC on 20 December 2020. Since Xavier has acquired the land no later than 12 months after the new build received its CCC, the new build exemption applies to enable Xavier (as an early owner) to deduct interest he incurs in relation to the land. It does not matter that the new build received its CCC before 27 March 2021.



Steph acquires the residential land from Xavier on 31 October 2022.



The new build exemption does not apply to Steph in respect of the land, because Steph acquired the land more than 12 months after the new build on the land received its CCC (she is a subsequent purchaser) and the new build received its CCC before 27 March 2021. It does not matter that the new build exemption previously applied to Xavier in respect of the land – this does not affect the application of the exemption to Steph.

Who should the exemption apply to and for how long?

8.20 The Government is interested in your views on who the exemption should apply to and for how long. The Government is considering three options:

- **In perpetuity for early owners.** The exemption would apply for the entire time an early owner retains their interest in the land.
- **In perpetuity for early owners and a fixed period for subsequent purchasers.** The period would start from the date a new build's CCC is issued and would not reset when the land is sold. For example, if a 20-year exemption applies and the early owner sells after seven years, the exemption would apply to the subsequent purchaser for the remainder of the 20-year period (that is, 13 years). There would be no limit on the number of subsequent purchasers a property could have within the fixed period.
- **For a fixed period for both early owners and subsequent purchasers.** The period would start from the date a new build's CCC is issued and would have a fixed time limit that applies to both early owners and subsequent purchasers, for example 20 years. If an early owner acquires a new build off the plans, it is proposed that the exemption would apply to them from the date they acquire the property. The fixed period the

exemption runs for would still be calculated from the date a CCC is issued for the new build.

- 8.21 The impact of the new build exemption on house prices and on the supply of new builds will depend on both the length of the exemption and whether it can be passed on to subsequent investors:

Impact on house prices

- **Length of the exemption:** A longer exemption allows for more interest deductions by investors. Therefore, a longer exemption will dampen house prices by less than a shorter exemption.
- **Ability to pass on the exemption:** The ability to pass on the exemption to subsequent purchasers supports resale value and will dampen house prices by less than if the exemption cannot be passed on.

Impact on supply of new builds

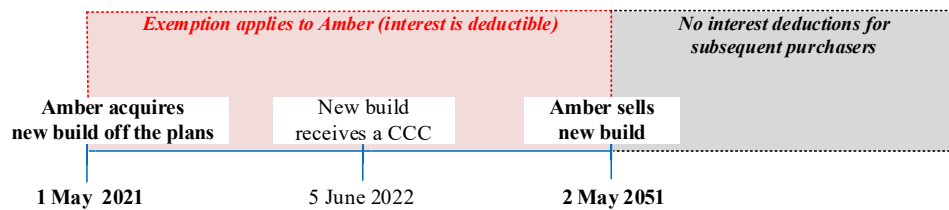
- **Supply response:** The removal of interest deductibility could reduce the incentive to build in the short-term, by reducing house prices. Since longer exemptions have less impact on house prices, it follows that longer exemptions and allowing the exemption to be passed on to subsequent buyers could have less negative impact on housing supply than shorter exemptions. However, the extent to which interest limitation will reduce housing supply remains unclear.

Example 28: Different application periods

The examples below assume that the residential land is rented out and that interest would have been deductible in the absence of the proposed new interest limitation rule. They also assume that if the exemption applies for a fixed period, it applies for 20 years from the date a CCC for a new build is issued.

In perpetuity for early owners

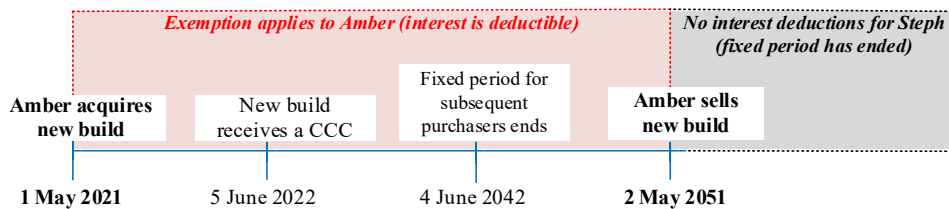
Amber enters into an agreement for an off the plans acquisition of a residential investment property on 1 May 2021. The new build receives its CCC on 5 June 2022, and title transfers to Amber at this time. Amber is an early owner of the new build so may deduct interest in relation to the new build (and the land that it is on) for the entire length of time Amber retains her interest in the land. For example, if Amber decides to sell the land on 2 May 2051, then she will be able to deduct interest up until this point (so for 30 years). The subsequent purchaser of the land, who acquires it from Amber in 2051, would not get any interest deductions under the new build exemption.



Alternate facts – in perpetuity for early owner, fixed period for subsequent purchasers

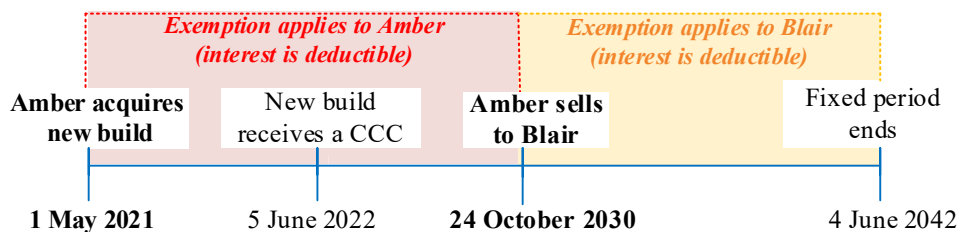
Same facts as the in-perpetuity example

Amber sells the land on 2 May 2051 to Steph. Amber may deduct interest up until this point (so for 30 years). The new build exemption does not apply to Steph because more than 20 years have passed since the CCC for the new build was issued (the CCC was issued on 5 June 2022, which was almost 30 years ago).



Alternate facts: Amber sells land in 2030

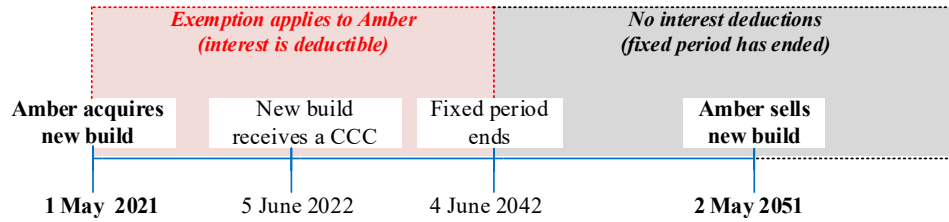
Amber sells the land to Blair on 24 October 2030. The exemption applies to allow Amber to deduct interest for the period she has the land (so from 1 May 2021 until 24 October 2030). The exemption also applies to allow Blair to deduct interest from 24 October 2030 until 4 June 2042, because it applies for 20 years from the date the new build's CCC was issued.



Alternate facts – fixed period for early owner and subsequent purchasers

Same facts as the in-perpetuity example

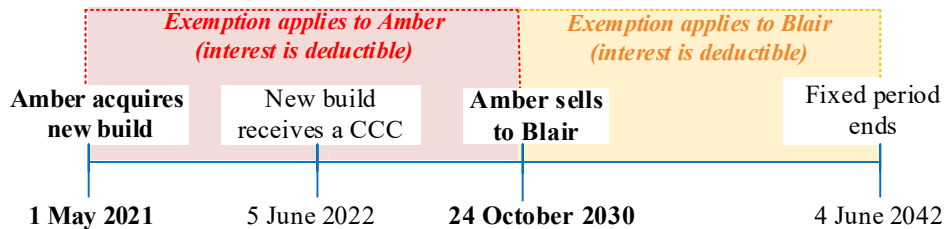
Amber holds the land until 2 May 2051.



The exemption only applies until 4 June 2042, which is 20 years after the date the new build’s CCC is issued. Any interest incurred by Amber in relation to the land between 5 June 2042 and 2 May 2051 is not deductible under the exemption.

Alternate facts: Amber sells land in 2030

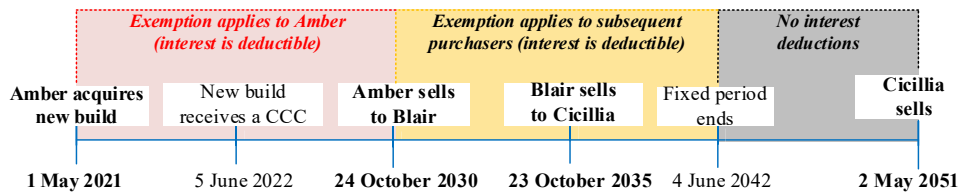
Amber sells the land to Blair on 24 October 2030.



The exemption applies to allow Amber to deduct interest for the period she has holds the land (so from 1 May 2021 until 24 October 2030). The exemption also applies to allow Blair to deduct interest from 24 October 2030 until 4 June 2042, because it applies for 20 years from the date the new build’s CCC was issued.

Alternate facts: Blair sells the land in 2035

Instead of retaining the land until the exemption expires in 2042, Blair sells the land to Cicillia on 23 October 2035. Cicillia holds onto the land until 2 May 2051.



Applying the exemption, Blair may deduct interest incurred in relation to the land until he sells the land to Cicillia (so up until 23 October 2035). Cicillia may deduct interest incurred in relation to the land from 23 October 2035 until 4 June 2042. From 5 June 2042 until she sells the land on 2 May 2051, Cicillia is unable to deduct interest incurred in relation to the land, because the exemption no longer applies.

Impact of use as main home on new build character

- 8.22 The Government invites your views on whether a property should cease to qualify for the new build exemption once it has been lived in by an owner-occupier ('continued investment rule'). If this were the case, then where a new build is initially used as a rental property, interest would be deductible for that period. If the new build is later lived in by an owner-occupier, interest would not be deductible (in accordance with existing tax rules). If the property were to be rented out after it is lived in by an owner-occupier, interest would not be deductible.
- 8.23 The continued investment rule would have a greater effect in terms of directing investors to invest in new property, rather than existing property, compared with not having such a rule. The rule would mean that a new build would *only* qualify for the exemption if it has always been used as an investment property, which means more new builds will cease to be eligible for the new build exemption sooner.
- 8.24 Applying the rule means that if an early owner of a new build:
- lives in the new build, the new build will never be eligible for the exemption;
 - uses the new build as an investment property initially for a period and then moves into it, no exemption would be available in respect of the property for subsequent purchasers; or
 - uses the new build as an investment property and then sells the new build to a subsequent purchaser who lives in it, the property will cease to be eligible for the exemption once the subsequent purchaser starts to live in it, even if the subsequent purchaser later sells the property to an investor.
- 8.25 The continued investment rule would mean that subsequent purchasers will not be able to just consider the CCC date for a new build to determine whether the exemption applies to them, if the exemption applies for a fixed period from the date a new build's CCC is issued – they will also need to ascertain whether it has ever been owner-occupied.
- 8.26 However, as mentioned above, the continued investment rule would ensure that the exemption ceases to apply to more new builds sooner. It would also ensure that owner-occupied properties, no matter the build date, are treated the same way. The Government is interested in your views on how practicable it would be to have the continued investment rule, and whether you think the rule supports the objective of the new build exemption. Things to consider include:
- maximising the incentive for developers to construct new builds and sell them;
 - discouraging the accumulation of 'old' new builds that qualify for the exemption, in order to best support the Government's objective of dampening investor demand for existing housing stock;
 - ease of compliance and administration; and

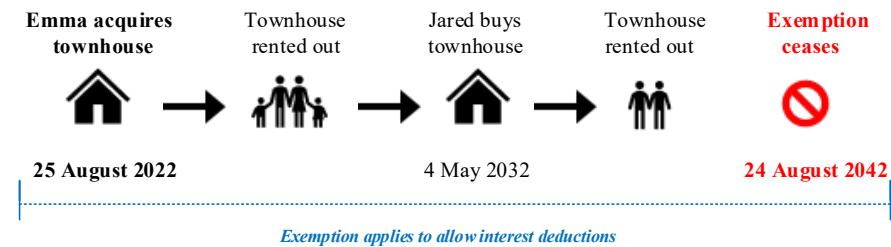
- any equity issues arising both between owners of new builds who are owner-occupiers or investors, and potential subsequent purchasers who could be owner-occupiers or investors.

Example 29: applying the continued investment rule

This example assumes a twenty-year fixed period applies to both early owners and subsequent purchasers.

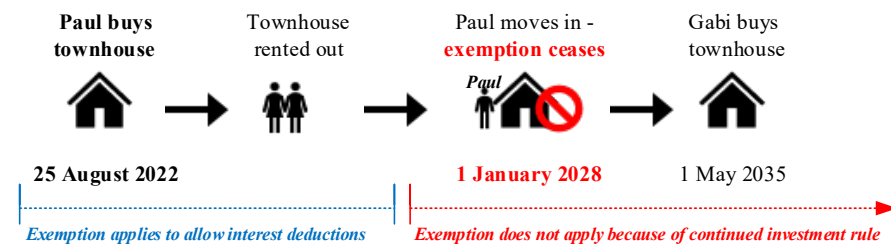
Two completed townhouses in the same complex are purchased by Emma and Paul. The townhouses receive their CCCs, and title is registered for each townhouse on 25 August 2022 to Emma and Paul respectively.

Emma holds onto her townhouse until 4 May 2032. She uses the new build as a long-term residential rental for this period. She may deduct interest incurred in relation to the new build until she sells it to Jared. Jared buys the house from Emma on 4 May 2032 and continues to use it as a rental property. Jared may deduct interest he incurs in relation to the property until 24 August 2042, which is when the fixed period the new build exemption applies for expires.



Paul rents his townhouse out until 31 December 2027. He may deduct interest incurred in relation to the townhouse from the date he acquires it until 31 December 2027. He then decides to move into the townhouse on 1 January 2028, and lives in it until 1 May 2035, at which point he sells it to Gabi. Gabi then rents the property out.

Even though Gabi is using the townhouse as a rental property, she may not deduct any interest she incurs in relation to the townhouse. The continued investment rule applies to stop interest deductions for the property from the point Paul lives in the townhouse as an owner-occupier. It does not matter that the property is later used as an investment property by Gabi.



This example illustrates how two properties that are identical could have different tax outcomes because of the continued investment rule. Even though Jared and Gabi own properties that are virtually identical, assuming all their costs are the same and they receive the same amount of rent for their townhouses, Jared would be better off than Gabi because he is able to deduct interest until 24 August 2042, but Gabi is not able to deduct any interest she incurs in relation to her townhouse.

Gabi would be aware however when she purchases the property that it has previously been occupied by Paul, and she may adjust the amount she is willing to pay for the

property to take the lack of interest deductions available to her in respect of the property into account. Paul's decision to move into his townhouse may be distorted by the continued investment rule, however, because by moving into the property he is likely to negatively impact upon the house's resale value.

What apportionment rules should apply?

- 8.27 Where a new build and a non-new build that are on the same title are purchased, existing apportionment principles would apply. The new build exemption would only apply to interest on the portion of the purchase price borrowing that relates to the new build.
- 8.28 Where a taxpayer adds a new build to land that already has a non-new build on it, the taxpayer would be allowed interest deductions for all borrowings incurred to add the new build to the land. Interest deductions for borrowings used to acquire the land, and any interest costs for other borrowings that relate to both the new build and the existing dwelling, would need to be reasonably apportioned between the new build and the existing dwelling. Apportionment would be on the basis of existing principles.
- 8.29 The Government invites your views on whether you support apportionment applying for complex cases, or if you would prefer a different approach. If apportionment were not allowed, then separate title could be required for any new build added to land, so that any new builds are not on the same title as old builds. Alternatively, a predominant test could apply, so in cases where more land area is covered by a new build than a non-new build, the new build exemption would apply to allow deductions for any interest that relates to the land (including the non-new build on the land).

Questions for submitters

Comments on all aspects of the proposals are welcomed. Below are several questions that the Government would specifically like to seek feedback on from submitters:

- Should the new build exemption apply only to early owners, or to both early owners and subsequent purchasers?
- What application period for the exemption do you think best achieves the objective of incentivising (or not disincentivising) continued investment in new housing? The options are: in perpetuity for an early owner only; in perpetuity for an early owner and for a fixed period for subsequent purchasers; or for a fixed period for both the early owner and subsequent purchasers.
- Are there any issues that specifically relate to the new build exemption and:
 - papakāinga housing?
 - heritage buildings?
 - the purpose-built rentals sector?
- How should the new build exemption from the interest limitation rule apply where interest relates to both a new build and a non-new build? Do you agree with the proposed approach (which would require apportionment rules to be applied), or do you prefer an alternative approach (such as requiring separate title or applying a predominant test)? (Refer to paragraphs 8.27 to 8.29 for more information).
- Do you have any suggestions for simple ways to prove that a person qualifies for the new build exemption, or ways that Inland Revenue could use existing data to check eligibility?
- What issues might result from relying on CCCs to verify that a person (and their land) is eligible for the new build exemption? Are there particular integrity issues the Government needs to consider?
- What could be used to verify that a person who acquires a property off the plans is eligible for the new build exemption, if that person wants to deduct interest before a CCC is issued?
- How practicable is the continued investment rule (described from paragraphs 8.22 to 8.26)? Do you think the rule is a good idea (considering the criteria mentioned in paragraph 8.26)?

Chapter 9

Five-year bright-line test for new builds

What does this chapter cover?

- 9.1 This chapter considers the design of the five-year bright-line test for new builds (“new build bright-line test”). It sets out what the new build bright-line test is and who it is proposed that the test would apply to. The Government’s proposed definition of new build is covered separately in chapter 7. The Government invites your views on how the new build bright-line test should be designed.

Background

- 9.2 The bright-line test taxes gains from residential land disposed of within a specified period (the “bright-line period”) after the transfer of the land to the person was registered on the title, subject to limited exclusions (such as for the main home). If a person disposes of land before they are registered on the title, the bright-line period runs from the date the person entered into an agreement to purchase the land (or the date they otherwise acquired an interest in the land).
- 9.3 The length of the bright-line period depends on when the land was acquired. If land was acquired on or after 29 March 2018 but before 27 March 2021, a five-year bright-line period applies. For land acquired on or after 27 March 2021, the general bright-line period is now ten-years, unless an exclusion³³ or the new build bright-line test applies to the land.

What is the new build bright-line test?

- 9.4 The new build bright-line test is proposed to apply to all or part of a piece of residential land that has a “new build” on it, but only if the land is acquired on or after 27 March 2021.³⁴ The Government’s proposed definition of new build is discussed in chapter 7. If the new build bright-line test applies, then a five-year bright-line period applies instead of the general ten-year bright-line period.

Other settings for the ten-year bright-line test apply

- 9.5 Excluding the length of the bright-line period itself, the Government proposes that the new build bright-line test would have the same settings as the general

³³ There are exclusions for main homes, inherited property, and land transferred under settlements of relationship property – refer to sections CB 16A, CB 6A(12), FC 9, and FB 3A.

³⁴ For tax law purposes, land acquired before 27 March 2021 that is subdivided after this date will be subject to the previous rules (for example, the five-year bright-line test that applied for land acquired on or after 29 March 2018 but before 27 March 2021). The five-year new build bright-line test will not be relevant.

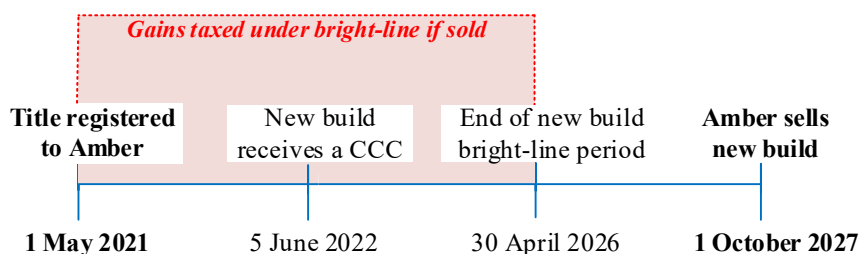
ten-year bright-line test. For example, the recent amendments to how the main home exclusion applies would also apply for the new build bright-line test.³⁵

When would the new build bright-line period start and end?

9.6 The bright-line period would start and end in the same way as the general bright-line test. This means the bright-line period would generally start on the date title for residential land³⁶ is registered to a person, and end on the date the person disposes of the land.

Example 30: Bright-line period

Amber acquires title to bare residential land on 1 May 2021. Amber adds a new build to the land, which receives its CCC on 5 June 2022. Amber rents the new build out, and then sells it on 1 October 2027.



The bright-line period begins on 1 May 2021 when title was issued to Amber, not from the date the new build received its CCC. Therefore, Amber will not be taxed on the gains when she sells the land on 1 October 2027, because that is more than five years after title for the land is transferred to Amber.

The new build bright-line test applies to early owners

9.7 The Government proposes that the new build bright-line test would only apply to early owners³⁷ of new builds (the proposed definition of new build is set out in chapter 7). “Early owner” has the same meaning for both the new build bright-line test and the new build exemption from the proposed interest limitation rule. As mentioned in paragraph 8.10, an early owner is a person who:

- acquires residential land with an already constructed new build on it, no later than 12 months after a CCC is issued for the new build,³⁸

³⁵ For more information, see <https://taxpolicy.ird.govt.nz/-/media/project/ir/tp/publications/2021/2021-sr-arferm-act/2021-sr-arferm-act-pdf.pdf>

³⁶ This is also the case for commercial land that is converted to residential land before sale. Refer to paragraph 7.8 for more information on commercial to residential conversions and when these would qualify as new builds.

³⁷ It is not proposed that the new build bright-line test would apply to subsequent purchasers.

³⁸ The rationale for allowing anyone who acquires a new build within 12 months of its CCC being issued to be an “early owner” is to ensure the first genuine investor is able to benefit from the new build bright-line test. A new build may change hands a number of times before it is finally acquired by a person as a long-term investment property.

- acquires a new build off the plans (it does not matter if the new build's CCC is issued more than 12 months after acquisition); or
- adds a new build to residential land, which includes simple new builds (refer to paragraph 7.5); complex new builds (refer to paragraphs 7.6 and 7.7); and commercial to residential conversions (refer to paragraph 7.8). (It does not matter if the CCC is issued more than 12 months after acquisition).

9.8 As mentioned above, the new build bright-line test only applies to new builds on land acquired on or after 27 March 2021. For the new build bright-line test to apply instead of the general ten-year bright-line test, a CCC for the new build must be issued by the time the land is sold by the early owner. This requirement is necessary so that Inland Revenue can objectively verify that the new build bright-line test applies.

New build includes second homes, holiday homes and vacant homes

9.9 The new build bright-line test could potentially apply to all residential land that has a new build on it, regardless of what the land is used for, unless an exclusion applies (such as the main home exclusion). It does not matter whether a new build is rented out long-term, left vacant, used as a second home or holiday home, or is rented out as short-stay accommodation.

Example 31: New build initially main home and then used as short-stay rental

James purchases a completed new build. He receives title for the land on 3 October 2022. The land has a new build on it which received its CCC on 5 June 2022. James lives in the property for three years as his main home. James then rents the new build out as short-stay rental accommodation from 3 October 2025 until he sells the land on 3 April 2027.

The diagram is a horizontal timeline with the following key events and dates marked below the axis:

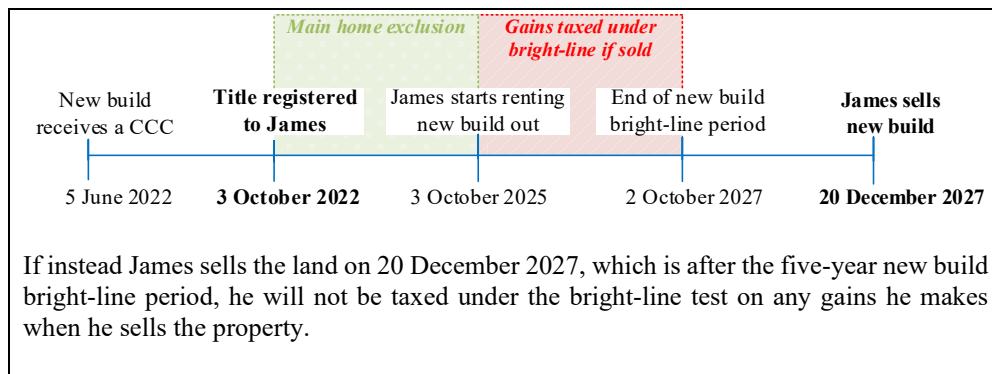
- 5 June 2022: New build receives a CCC
- 3 October 2022: Title registered to James
- 3 October 2025: James starts renting new build out
- 3 April 2027: James sells new build
- 2 October 2027: End of new build bright-line period

Two shaded regions are shown above the timeline:

- A green shaded region from 3 October 2022 to 2 October 2025, labeled "Main home exclusion".
- A red shaded region from 3 October 2025 to 3 April 2027, labeled "Gains taxed under bright-line if sold".

The bright-line test would not apply to tax any gains on sale for the period James lived in the property as his main home (from 3 October 2022 to 2 October 2025)³⁹. However, the gain in respect of the period that James rented the property out (from 3 October 2025 to 3 April 2027) would be taxed under the new build bright-line test, because James sold the property within five years of the title being registered to him. It would not make any difference if the facts were reversed, and James rented the property first and then occupied it as his main home.

³⁹ The amount James is treated as deriving on the sale is adjusted under section CB 6A(6) and (7), to reflect his main home use.



Apportionment for complex cases

- 9.10 The Government proposes that apportionment rules would apply for complex cases, which are when a dwelling is added to residential land that has an existing dwelling on the same title (refer to paragraphs 7.6 and 7.7 for more information on complex cases). Apportionment would be required where a new build is on a piece of residential land that has both a new build and a non-new build dwelling on it. The apportionment will ensure that only the portion of the land which has the new build on it will benefit from the new build bright-line test. The non-new build portion of the land will still be subject to the general ten-year bright-line test.
- 9.11 Existing tax principles for apportionment would apply to determine the amount of gains on sale that are taxed where only part of a property qualifies for the new build bright-line test. This means that the apportionment needs to be reasonable.
- 9.12 Under current law, apportionment would not apply when the land is predominantly used as a main home. In that case the main home exemption would apply (in section CB 16A).
- 9.13 The Government invites your views on whether you support apportionment for complex cases, or if you prefer a different approach. An alternate approach could involve a predominant test, under which the new build bright-line test would apply to the entire piece of land provided that more land area is covered by a new build than a non-new build.

Questions for submitters

Comments on all aspects of the proposals are welcomed. Below are several questions that the Government would specifically like to seek feedback on from submitters:

- Are there any issues that specifically relate to the new build bright-line test and heritage buildings?
- How should the new build bright-line test apply to complex new builds (where a new build and non-new build are on the same title)? Do you agree with the proposed approach, which would require apportionment rules to be applied, or do you prefer an alternative approach (such as applying a predominant test)?
- Are there any simple ways to prove that residential land a person owns qualifies for the new build bright-line test?
- Are there issues with relying on CCCs to verify that a property is eligible for the new build bright-line test? Should special rules apply if a CCC for a new build is not issued until some years after construction finishes?

Chapter 10

Rollover relief

Introduction

- 10.1 This chapter considers whether rollover relief may be provided for certain disposals that would otherwise result in interest deductions being denied or the bright-line test applying.
- 10.2 This chapter primarily deals with disposals where there is largely no change in the economic ownership of the land. This chapter does not seek to address all possible structures used to hold residential property; it covers the most common scenarios where integrity risk is limited. In the context of residential property, the Government considers it is sufficient to cover family trusts, look-through companies, and partnerships.
- 10.3 Where there is divergence from this approach, it is based on existing relief provided in the Income Tax Act 2007 (for example, as part of a relationship property agreement or inheritance). For interest limitation, rollover relief would be provided regardless of whether there is no consideration, partial consideration, or full consideration for the transfer of the land. However, for the bright-line test, rollover relief would be limited to situations where there is no consideration.
- 10.4 In the context of the interest limitation rules, the provision of rollover relief would be relevant for the proposed four-year phase-out period for land originally acquired before 27 March 2021, as well as for the new build exemption if it applies in perpetuity (as it would treat early owners and subsequent purchasers differently) as outlined in chapter 8.
- 10.5 In the context of the bright-line test, rollover relief proposed in this chapter would effectively ignore certain disposals so that a taxpayer is not inadvertently brought into the bright-line rules or taxed on a gain where there is no real change in ownership.
- 10.6 Submissions are sought from Māori regarding the impact of both sets of rules on the governance and administration of collectively-owned land received as commercial redress as part of a Treaty settlement, particularly where rollover relief could be provided. This could include, for example, land transferred to a post-settlement governance entity and then ultimately to hapū.

Other bright-line transactions

- 10.7 The Government is aware of other transactions that can result in an income tax liability arising under the bright-line test, often in the context of family arrangements where the taxpayer is not aware of the potential tax consequences of their actions.
- 10.8 For example, parents may help their children onto the property ladder by gifting them residential land or selling it to them at cost. Under the Income

Tax Act 2007, section GC 1 deems these transactions to occur at market value. This is an important feature of New Zealand's tax system to ensure integrity and fairness. However, it can create cash-flow difficulties when an income tax liability arises under the bright-line test.

- 10.9 These transactions are not dealt with in this discussion document due to the primary focus on the proposed interest limitation rules, and the complexity and variability of these arrangements. The Government is interested in undertaking work in this area at a later date.

What is rollover relief?

Bright-line test

- 10.10 The bright-line test provides that when a residential property is disposed of within ten years of acquisition, the net income is taxable. Under the current bright-line test, when residential land is gifted or sold below market value, the deemed gross income for the disposal is the market value of the property. This is an integrity measure, but there are some circumstances where a disposal may not be an appropriate taxing point because of overriding fairness, efficiency, or compliance cost concerns. In such cases, it may be preferable to apply rollover treatment to ignore the disposal for the purposes of the bright-line test.
- 10.11 Rollover relief is not an exemption from income tax. In the context of the bright-line test, rollover relief defers the taxing point until there is a subsequent disposal of the property that does not qualify for rollover relief. To achieve this, rollover relief disregards an intervening disposal by treating the transfer as a disposal and acquisition for an amount that equals the total cost of the residential land to the transferor at the date of the transfer. For the purposes of the bright-line test, the recipient is deemed to take on the transferor's original date of acquisition.
- 10.12 Limited rollover relief is currently available under the bright-line test. It was originally introduced as a two-year test and so extensive rules providing for rollover relief were not designed.⁴⁰ Rollover relief is currently only provided for residential land transferred under a relationship property agreement and for amalgamations. However, full relief is provided in relation to inherited property.

Interest limitation

- 10.13 In the context of the interest deductibility proposals rollover relief involves disregarding transfers or disposals in defined circumstances. Rollover relief may need to be considered in relation to certain transfers of land purchased before 27 March 2021 or of land containing a dwelling covered by the new build exemption.

⁴⁰ A two-year bright-line test applied for residential land acquired between 1 October 2015 and 28 March 2018, and a five-year test applies for residential land acquired between 29 March 2018 and 26 March 2021. The ten-year bright-line test applies to residential land acquired on or after 27 March 2021.

- 10.14 For land acquired before 27 March 2021, rollover relief would enable the new owner to continue to deduct a portion of their interest expense until 31 March 2025.
- 10.15 Chapter 8 on the proposed exemption from the interest limitation proposal for new builds seeks submissions on whether the exemption should apply in perpetuity to early owners (that is, persons acquiring the property before or within 12 months after the issue of the code compliance certificate under the Building Act 2004).
- 10.16 If the exemption from the interest limitation proposal for new builds is to apply in perpetuity to early owners, there is a question as to whether rollover relief may be required in situations such as transfers upon death or under relationship property settlements, or where property is transferred but the economic ownership of the property remains the same. For new builds, rollover relief would enable the new owner to deduct all their interest expense relating to the property. If rollover relief were not available, then they would not be entitled to any deduction for interest expense relating to the property.

Policy considerations

- 10.17 Reasons for rollover relief include fairness, efficiency, or other public policy concerns. There may be situations where there is a disposal for legal purposes or for the purposes of the Income Tax Act 2007, but no disposal of the land in substance. People should generally be able to conduct their affairs in the structure that they consider appropriate. The tax system should not penalise restructuring where there are genuine business or personal purposes, and such restructuring is within the law.⁴¹ Therefore, rollover relief may be appropriate to prevent an adverse tax outcome that may arise where a person disposes of land, but where that person has continuous economic ownership of that land.
- 10.18 For example, a sole trader landlord may decide that a limited liability structure is more appropriate for their rental business and transfer their rental property into a wholly-owned look-through company (LTC). The transfer of the property may trigger the bright-line test or make unavailable transitional rules regarding interest deductions. Arguably, there has been no disposal from an economic perspective, and therefore the landlord should not be disincentivised from transferring ownership of the land to the wholly-owned LTC.
- 10.19 Rollover might promote efficiency by reducing the “lock-in” effects of tax. “Lock-in” describes the incentive for taxpayers to retain assets because transferring or selling them would trigger a tax liability and/or lead to a loss of interest deductions.
- 10.20 If rollover relief is too extensive however, it could negate the benefits the bright-line test and the Government’s interest limitation proposal.

⁴¹ Including not being for the purpose of avoiding tax.

- 10.21 The objective is to develop rollover rules that are coherent and principled. The rules must be administratively workable and preserve the integrity of the tax system.

Existing relief under the bright-line test

- 10.22 The bright-line test provides that an amount derived on “disposing of residential land” is income of the person. However, some disposals of residential land attract rollover relief or are accorded full relief.
- 10.23 Whether a person “disposes” of land is generally determined using case law (with some modification by section YA 1). Further, the definition of “land” includes an estate or interest in land. Generally, disposals of land will include transfers of legal title of land under the Land Transfer Act 2017 (which can include settling land on trust, compulsory acquisitions, and mortgagee sales) and the disposal of an equitable interest in land. The disposal of land that is subject to the bright-line test at less than market value (including gifts) is generally deemed to be disposed of at market value.⁴²
- 10.24 Of these types of land disposals, rollover relief is currently available for relationship property and residential land held by an amalgamating company. These are discussed below. Rollover relief for the purposes of the bright-line test generally deems the person disposing of the land (the transferor) to be disposing of the land at cost, and the recipient to have acquired the land on the date the land was acquired by the transferor.
- 10.25 Inherited properties are provided full relief from income tax under the bright-line test. The transfer of a property from a deceased person to the beneficiary of the estate (even via an executor or administrator of an estate), is not a taxing event for the purpose of the bright-line test. In addition, land that a person has inherited from a deceased estate is not subject to the bright-line test even if the beneficiary sells it within the bright-line period. This effectively means that an inherited property is exempt from income tax under the bright-line test. This is provided for in sections CB 6A(12) and FC 9 of the Income Tax Act 2007.

Proposals

- 10.26 The Government proposes to afford rollover relief to certain disposals of land under the bright-line test and proposed interest limitation rules. This chapter uses the terms “full rollover relief” and “partial rollover relief”. Full rollover relief means that rollover relief would be provided in relation to the whole piece of land and the whole transaction. Partial rollover relief means that rollover relief would only be provided in relation to part of the land or one or more of the relevant parties involved in the transaction.
- 10.27 The scope of the rollover relief proposed in this chapter is not intended to capture every type of reorganisation that produces economically consistent outcomes, but only those that are most common and not complex.

⁴² Income Tax Act 2007, section GC 1.

- 10.28 The rollover relief proposed would apply to effectively prevent the bright-line test from applying at a particular point in time and/or allow the continued deduction of interest expenses following a disposal, generally where the economic ownership of the land has not changed. It would not permit taxpayers to undertake activities that might otherwise constitute tax avoidance (for example, restructuring purely to obtain a lower tax rate). The general anti-avoidance rule in section BG 1 of the Income Tax Act 2007 would continue to apply, along with specific anti-avoidance rules such as those in sections GB 52 and GB 53 of the Income Tax Act 2007.
- 10.29 Rollover relief would be available for each disposal that meets the relevant criteria. Therefore, a single parcel of land could be subject to multiple instances of rollover relief within the bright-line period.

Bright-line test rollover

- 10.30 For the purposes of the bright-line test, this rollover relief would generally of treat the disposal of the residential land as at cost to the transferor or original owner (rather than at market value as provided in section GC 1), and treating the recipient as having the same acquisition date and cost base as the transferor.
- 10.31 Disposals where there is non-zero consideration (either at market value or not) would not be eligible for rollover relief. This is because such a transaction would, to the extent of the consideration, be a realisation of the value of the land, and providing roll-over relief in this context may give rise to integrity concerns. Rollover relief proposed in this chapter would therefore apply where the residential land is disposed of within the bright-line period for zero consideration (that is, gratuitously). Rollover relief would also be available in some limited situations – for example, where a settlor settles land onto a trust in return for the trust providing the settlor the right to occupy the property free of charge.
- 10.32 For the bright-line test proposals in this chapter, the Government proposes that rollover relief be provided in relation to a disposal that occurs on or after 1 April 2022, even if the original acquisition predates the introduction of the bright-line test. This would ensure that a property that has been owned by a person for several decades would not be brought within the ten-year bright-line test simply because the owner settles the property on trust in 2022, for example.

Interest limitation rollover

- 10.33 For the purposes of the proposed interest limitation rules, rollover relief would consist of treating the recipient as having the same acquisition date as the person who disposed of the land.
- 10.34 The rollover relief proposed in relation to the interest limitation would only apply to allow the continued deduction of interest expenses following a disposal, generally where the economic ownership of the land has not changed. It would not permit taxpayers to undertake activities that might otherwise constitute tax avoidance (for example, restructuring purely to obtain a lower

tax rate). The general anti-avoidance rule in section BG 1 of the Income Tax Act 2007 would continue to apply, along with any specific anti-avoidance rules that would apply in the context of the interest limitation rules.

- 10.35 The rollover relief proposed in this chapter for the interest limitation rule would apply to land transfers on or after 27 March 2021 where the land was first acquired by the person disposing of it before 27 March 2021. If the new build exemption is to apply to initial or early purchasers of new builds in perpetuity, the Government considers that it would generally be appropriate for rollover relief for interest limitation to also apply to transfers of residential land occurring on or after 27 March 2021 in situations where the person disposing of the land was exempt from the interest limitation rules, owing to the property being a qualifying new build.

Relationship property settlements

Bright-line test

- 10.36 An existing rule provides rollover relief from the bright-line test for transfers of residential land from a settlement of relationship property. Section FB 3A of the Income Tax Act 2007 provides that when residential land is transferred on a settlement of relationship property, the transfer is treated as both a disposal and acquisition for an amount that equals the total cost of the residential land to the transferor at the date of transfer. This has the effect of no tax liability arising under the bright-line test for such property transfers.
- 10.37 However, the person to whom the property has been transferred may be liable under the bright-line test for any subsequent disposal of the property. The recipient takes on the transferor's date of acquisition for the purposes of the bright-line test under section FB 3A(3), meaning they obtain the benefit of the previous owner's years of ownership to determine whether they are within or outside the bright-line period. If the recipient disposes of the residential land within the bright-line period, they receive a deduction for the original owner's acquisition cost when calculating their net income.
- 10.38 The Government is not proposing any changes to the treatment of relationship property settlements under the bright-line test.

Interest limitation

- 10.39 The Government proposes that rollover relief be provided for pre-27 March land transferred under a relationship property settlement. If the new build exemption from interest limitation is to apply to initial or early purchasers in perpetuity, the Government proposes that rollover relief also apply to transfers of land covered by the new build exemption under relationship property settlements.

- 10.40 There may be justification for rollover relief on the basis that “relationship property”⁴³ was always jointly owned. In effect, the argument is that any transfer in the course of a relationship property settlement is just giving effect to what had always been the case in an economic sense. However, this will not always be precise, especially given the rather uncertain nature of ownership rights in many relationships. For example, people may sometimes transfer some “separate property”⁴⁴ in the course of a settlement because the separate property was more liquid or divisible than the relationship property.
- 10.41 The objective is to ensure that tax is as little of a factor in people’s personal relationship choices as possible. The Government would like the rules to be simple enough so that people can easily self-assess if rollover relief applies and understand what they need to do (keeping in mind that people should seek legal advice, particularly in separations involving significant assets).

Example 32: relationship property agreement

Tom and Tory, a married couple, decide to separate in 2023. In the relationship property agreement, Tory transfers a second home to Tom - a new build that she acquired in April 2021 as an investment property when she was still single—and they arrange for the mortgage to be solely in Tom’s name. Rather than move into the property himself, Tom keeps it as a rental investment property, opting to instead move into an apartment that is closer to his workplace.

Since the property is a new build that was acquired by Tory after 27 March 2021, (meaning that Tory was entitled to continue deducting all her interest in relation to the property after 1 October 2021), rollover relief applies to the transfer of the property to Tom. This means that Tom is entitled to deduct interest on the mortgage for the property, as the transfer of the property from Tory to Tom is effectively ignored when determining whether interest deductions are available in relation to the property.

Example 33: relationship property agreement

Dale and Dawn, a married couple, decide to separate in April 2022. As part of the relationship property settlement, they agree that Dale will keep the family home and Dawn will keep the investment property they acquired back in 2003 shortly after they got married. Dawn decides to retain the property as an investment rather than move into it herself.

Since the property was acquired before 27 March 2021 the limitation of interest deductions is phased in over four years, and so Dale and Dawn (who both have standard balance dates) are entitled to deduct 75% of the amount of mortgage interest they each incurred in relation to the property over the period 1 October 2021 to 31 March 2022. Rollover relief applies to the transfer of Dale’s share of the property to Dawn in April 2022, so Dawn will be entitled to deduct a reducing amount of interest over the remaining phase-out period.

⁴³ Unless agreed otherwise by the spouses or partners, this generally includes things like the family home and chattels (regardless of when they were acquired); property owned jointly or in common in equal shares by the married couple or partners; property owned by either spouse or partner immediately before the marriage, civil union or de facto relationship began if it was acquired in contemplation of the relationship or it was intended for the common use or common benefit of both spouses or partners; and property acquired by either spouse or partner or by both of them after their marriage, civil union or de facto relationship began. For a full definition, see Property (Relationships) Act 1976, s 8.

⁴⁴ “Separate property” refers to all property of either spouse or partner that is not relationship property.

Transfers on death

Bright-line test

- 10.42 An exemption is provided from the bright-line test for transfers of residential land upon the death of the owner (including intervening transfers via an executor or administrator of the estate) as well as subsequent disposals by beneficiaries of the estate. Sections CB 6A(12) and FC 9 of the Income Tax Act 2007 effectively provide that inherited residential land is not taxed under the bright-line test. The Government is not proposing to change this treatment.

Interest limitation

- 10.43 When a person dies, all of their property (their “estate”) is transferred to the executor appointed under the deceased’s will or, if there is no will, the administrator of the estate appointed by the court. The executor or administrator is then responsible for dealing with any taxes and debts due out of the estate, and then distributing any remaining property to the people entitled to receive it under the will or the rules governing intestacy (the beneficiaries of the estate).
- 10.44 Generally, all of the deceased’s debt will be repaid by their estate when they die, provided there are sufficient assets to cover the debt. Even if the debt is not repaid in full, any remaining debts (such as mortgages) are not required to be repaid by the beneficiaries of the estate. However, there may be some situations where a property (over which a mortgage is registered) is transferred to a beneficiary of the estate and the beneficiary voluntarily continues to make the mortgage repayments so that they may keep the property.
- 10.45 Submissions are invited on whether rollover relief from interest limitation should be provided for transfers on death. If rollover relief is provided for transfers on death of land subject to the new build exemption, the Government considers that it would be appropriate to limit the availability of rollover relief - for example, by ensuring that the rollover relief only applies over the lifetime of the beneficiary receiving the property (that is, rollover relief for transfers on death can only occur once). Otherwise, if a house was to stay within a family over multiple generations, theoretically the beneficiaries could get full interest deductibility for many years, potentially well past the average person’s lifespan.

Example 34: inheritance of a property subject to the new build exemption

Lionel owns a rental property that he acquired as a new build (that is, within 12 months after the certificate of code compliance was issued) in December 2021. At the time of Lionel’s death, he owes \$125,000 on his mortgage. Lionel’s will provides for the property to be inherited by his adult son, Jake.

The executors of Lionel’s will ascertain that Lionel’s estate does not have sufficient cash assets to repay the loan in full. Instead of selling the property to cover the shortfall, Jake agrees to take out a mortgage to repay the loan.

Assuming that the new build exemption for interest limitation applies in perpetuity to original or early purchasers of new builds, Lionel was entitled to deduct all his interest expense paid on the mortgage indefinitely. If rollover relief is provided for transfers on

death, Jake is allowed to deduct all the interest expense he pays on the mortgage as he is treated as having acquired the property in December 2021, meaning that he effectively qualifies for the new build exemption.

Questions for submitters

- Should rollover relief from interest limitation be provided for transfers on death?
- If rollover relief is provided for properties subject to the new build exemption on death of an owner, does there need to be a time limit on the availability of relief?

Company amalgamations

Bright-line test

- 10.46 Under the bright-line test, rollover relief is provided in relation to company amalgamations, provided that the amalgamation qualifies as a resident's restricted amalgamation under section FO 3 of the Income Tax Act 2007. Effectively, relief is only provided if the amalgamating companies and the amalgamated companies are New Zealand resident and are not treated as non-resident under a tax treaty. This ensures that rollover relief is only provided where the asset remains in the New Zealand tax base.
- 10.47 The Government is not proposing any changes to how rollover relief is provided under the resident's restricted amalgamation rules for residential land subject to the bright-line test.

Interest limitation

- 10.48 The Government proposes that rollover relief for interest limitation would apply to a company amalgamation if the amalgamation qualifies as a resident's restricted amalgamation under section FO 3 of the Income Tax Act 2007. This would be consistent with the existing rollover relief provided under the bright-line test for company amalgamations.

Example 35: company amalgamation

In March 2015, A Co., a close company, purchases a number of residential apartments. On 1 October 2021 the properties are transferred from A Co. to another close company, B Co. as part of an amalgamation. The amalgamation qualifies as a resident's restricted amalgamation under section FO 3 of the Income Tax Act 2007.

Rollover relief applies to the transfer, meaning that B Co. is treated as having acquired the property in March 2015 and is therefore entitled to deduct a reducing amount of interest over the four-year phase-out period, starting at 75 percent of the total interest expense and reducing by 25 percent each year.

Natural persons who dispose of land to themselves

Bright-line test

- 10.49 Under New Zealand law it is possible for a person to transfer land to themselves.⁴⁵ The Government considers that natural persons transferring land to themselves should not be caught by the bright-line test to the extent that there is no ownership change in economic substance. Examples are:
- A person who owns land transfers it to joint ownership with another person – there is no ownership change as to 50% of the land
 - One of three equal tenants in common transfers their interest in land to the other two – there is no ownership change as to 2/3rds of the land.
- 10.50 It is not currently certain whether a change to the Income Tax Act 2007 is required to achieve these outcomes. Should a law change be required, the Government will introduce a legislative amendment alongside the legislation for the interest limitation rules. If no law change is required, appropriate guidance will be issued.

Example 36: sole owner to joint tenancy with partial disposal

Alexei acquires residential land as sole owner. Three years later, Alexei disposes of the title to himself and his business associate Brandon as joint tenants. If required, partial rollover relief would be explicitly provided in relation to Alexei's deemed ½ share of the land, such that Alexei would only be subject to the bright-line test at the time of the transfer in respect of the ½ share disposed to Brandon.

Example 37: joint tenancy to sole ownership with partial disposal

Friends Georgie and Bruce purchase residential land together as joint tenants on 18 March 2022. On 20 July 2024, Bruce disposes of his interest to Georgie, upon which Georgie has sole ownership. Georgie disposes of the residential land on 31 January 2033.

Bruce

For the disposal of Bruce's interest in the land as a joint tenant (deemed to be 50% of the land), Bruce is subject to the bright-line test. The bright-line period for Bruce's interest runs from 18 March 2022 until 20 July 2024.

Georgie

If necessary, rollover relief would be provided for the disposal of Georgie's interest in the land on 20 July 2024 as a joint tenant (deemed to be a ½ share of the land) to themselves in moving from joint tenancy to sole ownership. When Georgie disposes of this part of the residential land on 31 January 2033 (the deemed ½ share they have held since 18 March 2022) rollover relief would deem it to have been acquired on 18 March 2022. Therefore, the bright-line period for the land would begin on 18 March 2022 and would end on 31 January 2033 – the disposal is not subject to the bright-line test as Georgie is deemed to have held the ½ share for longer than ten years.

⁴⁵ See the Property Law Act 2007, section 56(1).

However, Georgie's disposal of the part they acquired from Bruce (the remaining deemed ½ share of the land) on 20 July 2024 would not attract rollover relief. Georgie would be subject to the bright-line test in respect of this portion given that Georgie has held the interest in land for less than ten years. (The bright-line period would begin on 20 July 2024 and end on 31 January 2033.)

Interest limitation

- 10.51 Similar to the proposals outlined above for the bright-line test, explicit rollover relief for the purposes of the interest limitation rules may be required for land acquired prior to 27 March 2021.

Example 38: sole ownership to joint tenancy (land acquired before 27 March 2021)

Consider Alexei and Brandon in example 36 above. Assume that Alexei had purchased the land in October 2018.

When Alexei disposes of the title to Brandon and himself as joint tenants, partial rollover relief would be provided, if necessary, in relation to Alexei's deemed 50% interest in the land (as was the case for the purposes of the bright-line test). This means that, for the purposes of the interest limitation rules, Alexei is treated as having acquired his nominal interest in October 2018 (as opposed to on 1 October 2021 when the disposal occurs). However, Brandon's share does not attract rollover relief because there has been a change in the economic ownership of that share.

At the time of purchasing the land, Alexei took out a loan to finance the purchase which has not yet been repaid in full. Alexei and Brandon have agreed that Brandon will contribute half of the remaining repayments of the loan. Alexei is entitled to a 75 percent deduction for the interest he pays on the loan between 1 October 2021 and the 31 March 2022, with the amount of the deduction for his share of the interest expense reducing to 50 percent and 25 percent over the next two years and to zero in the following year and thereafter.

- 10.52 If the new build exemption from interest limitation is to apply in perpetuity and only for early or initial purchasers of new builds, the Government considers that it would also be appropriate to provide rollover relief where residential property that is subject to the new build exemption may potentially be viewed as being disposed of under the scenarios outlined at paragraph 10.49.

Trusts

Bright-line test

- 10.53 **Settling land on trust:** Under the current bright-line test, a settlement of residential land on trust constitutes a disposal by the settlor and an acquisition by the trustee of the trust. Depending on the circumstances this can create an income tax liability under the bright-line test or restart the bright-line clock even if the settlor originally acquired the land prior to 1 October 2015.
- 10.54 Given the use of family trusts in New Zealand for ownership of residential property, many families could become subject to the bright-line test for a property they have owned for several years, simply because they decide to settle a property on trust which then sells the property within ten years of that settlement. This was also a possibility under the previous bright-line tests but

was less likely to occur given the shorter periods of two and five years. With a longer bright-line horizon, property owners may not be able to foresee the possibility of selling the property when planning their family trust affairs.

- 10.55 The Government therefore proposes full rollover relief for family trusts in relation to settlements of residential land on trust. A subsequent disposal by the trustee (such as a distribution to a beneficiary) would, be a disposal and may be taxable if disposed of within the bright-line period. The main home exclusion as it applies to trusts would continue to be available.
- 10.56 Specifically, the Government proposes that a disposal of residential land by a settlor or settlors to the trustees of a trust should be subject to rollover relief for the purposes of the bright-line test where the trust is a standard family trust.
- 10.57 To ensure that any proposed relief is appropriately targeted at common family trust situations, the Government seeks submissions on the use of trusts by New Zealand families to help set the conditions that should be imposed on this relief. At present, the Government proposes that three conditions would need to be met:
- every settlor of the land is also a beneficiary;
 - at least one of settlors of the land is a principal settlor of the trust;⁴⁶ and
 - every beneficiary (excluding the beneficiaries who are also principal settlors) is associated with a principal settlor.
- 10.58 The Government is primarily concerned with providing relief for disposals to family trusts. Therefore, the rules are designed to limit relief to trusts set up for the benefit of the family of the principal settlor.
- 10.59 The Government proposes that the settlors of the trust who settle the residential land would not need to be the only beneficiaries or have specific beneficial interests in the land under the trust. Otherwise, this would prevent many families from accessing the rollover relief proposal as children are likely to be beneficiaries of a trust but are unlikely to be the settlors settling the relevant residential land.
- 10.60 The Government therefore proposes that a modified set of association tests could be applied to determine whether a beneficiary is associated with a settlor. The modified association rules would be based off the broader association rules (that is, the rules that are not applicable to the land provisions)⁴⁷.
- 10.61 The association test for two relatives is expected to be broader than the current test (being two degrees of blood relationship) given the range of family members included in beneficiary definitions. The Government therefore seeks submissions on the most commonly included range of beneficiaries listed in family trust deeds in order to determine a reasonable number of degrees of

⁴⁶ Section CB 16A(7) provides that a principal settlor is a settlor “whose settlements for the trust are the greatest or greatest equal, by market value”. Therefore, multiple settlors can each be a principal settlor (eg a couple who jointly settle residential land on a trust for their family).

⁴⁷ To note, the bright-line test (section CB 6A) is not a “land provision” for the purposes of the Act.

blood relationship that should be permissible to determine whether a beneficiary is associated with the principal settlor. Some classes of beneficiaries beyond the determined number of degrees of blood relationship could also be permissible – for example, all descendants of the settlor.

- 10.62 Further modifications to the association rules may be required. For example, as a starting point, the Government envisages that a beneficiary should not be automatically associated with a settlor under section YB 9 of the Income Tax Act 2007, nor associated with the settlor through the combination of the tripartite test and sections YB 6 and YB 8. Further, a beneficiary or settlor would only be associated with a company where the beneficiary owns greater than 50% of the shares of the company.
- 10.63 While the requirements above may not be able to be satisfied by every family trust currently in existence in New Zealand, rollover relief could be obtained by amending the trust deed as necessary prior to the acquisition of the property, or a new (second) trust could be set up for the purposes of the disposal of residential property (provided the second trust is not set up for any tax avoidance purpose).

Example 39: settlement on family trust

Married couple Sunita and Ronald purchase residential land in their own names. Six months later Sunita and Ronald decide to settle the land on a trust with Sunita's sister and spouse as the trustees, and with themselves and their children as beneficiaries of the trust. The only property settled on the trust is the residential land.

Full rollover relief is proposed for the disposal of legal title to Sunita's sister and spouse as trustees on settlement of the trust. Sunita and Ronald are both beneficiaries of the trust. Sunita and Ronald are both principal settlors, given that the trust has no other property, and Sunita and Ronald have each made the greatest equal settlements. Sunita and Ronald are associated through marriage, and both non-settlor beneficiaries (the two children) are associated with a principal settlor (in this case, both settlors).

- 10.64 This relief would include a disposal of the land to oneself as trustee of the trust.

Example 40: disposal to oneself as trustee of a trust

Neo acquired residential land on 3 March 2017. On 29 October 2022, Neo settles the residential land on trust with himself and his son Archie as beneficiaries of the trust.

Current law

Neo is subject to the two-year bright-line test in relation to the property.⁴⁸ The settlement on trust is a disposal, but there is no tax liability under the bright-line test because Neo held the property for more than two years. However, the settlement on 29 October 2022 restarts the bright-line clock and the trustee of the trust would be subject to a ten-year bright-line test.

⁴⁸ The two-year test applied in relation to residential land acquired between 1 October 2015 and 28 March 2018.

Proposal

Full rollover relief would be provided and the settlement on trust on 29 October 2022 is effectively ignored. The trustee would take on Neo's acquisition date of 3 March 2017 and Neo's acquisition cost. A subsequent disposal in 2025, for example, would not be subject to tax under the bright-line test, because the two-year test applied when Neo first acquired the property.

- 10.65 The Government is also considering rollover relief where land is disposed of from one trust to a different trust. In such circumstances, relief could be made available where the beneficiaries of the two trusts are identical. The Government is interested in understanding how such a rule could be designed.
- 10.66 The land-rich trust avoidance rule will continue to apply and address some trust arrangements intended to avoid the operation of the bright-line test.⁴⁹ If beneficiaries were to be added after the disposal occurs, the Government expects that the land-rich trust avoidance rule would apply and deem a trustee to have disposed of residential land at market value.
- 10.67 **Change of trustees:** The bright-line test is not intended to capture a disposal of an interest in land when a person ceases to be trustee of a land-owning trust (provided beneficial ownership remains unchanged). Section CB 6A(5) of the Income 2007 was enacted to address this situation, but there are concerns that the provision does not achieve this intent. The Government proposes to clarify this provision and provide rollover relief to the trustee who is disposing of the interest in land to another trustee of the same trust. This would not, however, prevent the application of the land-rich trust rule where changes to decision-makers are made with the purpose or effect of defeating the intent and application of the bright-line test. The land-rich trust rule can apply to override section CB 6A(5) to disallow the rollover relief in this case, to ensure that the disposal is appropriately taxed under the bright-line test.

Interest limitation

- 10.68 The Government proposes that rollover relief should also apply for the purposes of the proposed interest limitation rules where a settlor (or multiple settlors) disposes of land to the trustees of a trust, and:
- every settlor of the land is also a beneficiary;
 - at least one of the settlors of the land is a principal settlor; and
 - every beneficiary who is not the principal settlor is associated with the principal settlor.
- 10.69 Similar to the proposal outlined above relating to disposals to trusts and rollover relief for the purposes of the bright-line test, it is proposed that the modified association test outlined at paragraphs 10.60 to 10.62 could apply to determine whether a beneficiary is associated with a settlor.

⁴⁹ Section GB 53 of the Income Tax Act 2007

- 10.70 The Government is also considering rollover relief for interest limitation purposes where a trust disposes of land to a different trust. As outlined above in the context of rollover relief for bright-line purposes, relief may be available where the beneficiaries between the two trusts are identical.
- 10.71 The Government considers that it would be appropriate to extend the land-rich trust avoidance rule in section GB 53 of the Income Tax Act 2007 so that it also applies for the purposes of the interest limitation rules, thus ensuring that trust arrangements cannot be used to avoid interest limitation.

Questions for submitters

- In your view, are the conditions proposed at paragraph 10.57 appropriately targeted at the most common family trust situations? Are there any alternative criteria that you would suggest?
- What number of degrees of blood relationship should be permissible to determine whether a beneficiary is associated with the principal settlor?

Look through companies (LTCs) and partnerships

- 10.72 The Government proposes that rollover relief would also apply where property is transferred between an LTC or partnership and its owners, so long as the property continues to be owned in the same proportions.
- 10.73 LTC shareholders are treated as directly holding the LTC's assets, deriving income, and incurring expenses in accordance with their shareholding percentage. This is the same for partners in a partnership. In effect, LTCs and partnerships are transparent for tax purposes, which means that the income tax consequences for someone who holds residential property directly are generally the same as for someone who instead holds residential property through an LTC or partnership.

Bright-line test

- 10.74 The process of transferring residential land from an individual into the LTC or partnership currently constitutes a bright-line disposal and acquisition.
- 10.75 The Government proposes that a disposal by a person to an LTC, where they are the sole shareholder should be subject to full rollover relief for the purposes of the bright-line test. Similarly, this should also apply to a group of persons, where the group are all shareholders in proportion to their interest in the land prior to the disposal, and in proportion to their cost base relative to the total cost base in the property (i.e. most commonly where the group of persons purchase the land at the same time). The relief would also be available in the

reverse where an LTC disposes of land to its shareholder(s) in proportion to their shareholding(s).⁵⁰

- 10.76 For partnerships, the Government proposes similar relief. A disposal of land by a group of persons should attract rollover relief, where the group hold partnership shares in proportion to their interest in the land prior to the disposal and in proportion to their cost base relative to the total cost base in the property. The relief would also be available in the reverse where a partnership disposes of land to the partners in proportion to their partnership interest.

Interest limitation

- 10.77 Similar to the proposal outlined above, the Government proposes that rollover relief should apply if land is transferred from a person to an LTC and the person is the sole shareholder in the LTC, or it is transferred from a group of persons to an LTC and the group are all shareholders in the LTC in proportion to their respective interests in the land prior to the disposal and in proportion to their relative cost bases.
- 10.78 The Government proposes that rollover relief should be provided for a disposal of land to a partnership when the partners' respective interests in the partnership are in proportion to their interests in the land prior to the disposal and are in proportion to their relative cost bases. Where a partnership disposes of land to the partners, rollover relief should be provided to the extent that the partners' respective interests in the partnership are in proportion to their interests in the land after the disposal.

Māori collectively-owned land

- 10.79 The Government is interested in receiving submissions on the impact of the bright-line test and the proposed interest limitation rules on the administration and governance of Māori collectively owned land and whether the relief proposed under this chapter could be extended to Māori authorities or other entities used to hold such land.⁵¹ This could include, for example, issues faced when transferring Māori collectively-owned land from one organisation to another, or when land is transferred from a post-settlement governance entity to hapū.

Māori authorities

- 10.80 While Māori authorities can be either a company or the trustees of a trust, the rollover proposals set out in this chapter only provide relief for transfers to trustees of a trust, and not to companies. At this stage therefore, those proposals would only apply to Māori authorities that are trustees. The proposals in this chapter have not included companies (excluding LTCs) given the greater complexity in ensuring that a transfer to a company maintains continuous effective economic ownership. However, the Government is

⁵⁰ The rollover relief would only apply to address section CB 6A – all other provisions may still apply (such as the dividend rules).

⁵¹ Note that charities registered under the Charities Act 2005 are exempt from income tax and therefore should not be impacted by the proposal.

interested in receiving submissions from companies who are Māori authorities on how the bright-line test and the proposed interest limitation rules may affect them.

- 10.81 The trust proposals may be too narrow considering the way Māori authorities are typically set up and used. For example, the trust proposal is limited to situations where every beneficiary is associated with the settlor. A different test (modification) may be appropriate for Māori authorities to account for how they are used to look after and grow assets for future generations, possibly by using a different connection test that considers blood-ties or whakapapa. The purpose of such a test is to ensure that beneficial ownership is maintained before and after a transfer of land to the Māori authority and if necessary, could be designed to take into account the fact that member interests in the communal assets held by the Māori authority can be diluted over time. This modification would need to be accompanied with a suitable limitation so that the relief provided by rollover cannot be arbitrarily expanded (for example, the beneficiaries both before and after transfer are all members of a particular hapū or iwi).
- 10.82 To the extent that an election to become or cease to be a Māori authority results in a deemed disposal and reacquisition at market value, the Government is considering whether specific rollover relief would be required under the interest limitation rules or bright-line test.

Questions for submitters

- Would the trust proposal in this chapter be appropriate for Māori authorities that are trustees?
 - Would a connection other than association to a settlor be more appropriate? (For example, being a member of a particular hapū or iwi)
 - How could this work for Treaty settlement land?
 - Are there issues with dilution that need to be considered?
- Are transfers of residential land from one Māori authority to another Māori authority common?
 - To what extent are the Māori authorities involved in such transfers companies?
 - For what reasons are these transfers occurring (for example, simple restructuring)?
- Are there any issues that arise under the bright-line test or interest limitation rules where rollover relief may be appropriate? Some potential examples include:
 - Other situations where residential land is transferred to a Māori authority.
 - An election to become or cease to be a Māori authority.

- A transfer of treaty settlement land from a post-settlement governance entity or iwi to hapū.

Chapter 11

Interposed entities

Introduction

- 11.1 Interposed entity rules are required to support the integrity of the interest limitation rule. The rules need to address situations where a taxpayer borrows money to acquire an ownership interest⁵² in an entity that owns residential investment property subject to the interest limitation rules. This chapter proposes an approach informed by the existing interposed entity rules for residential loss ring-fencing,⁵³ with some important modifications.

Why interposed entity rules are required

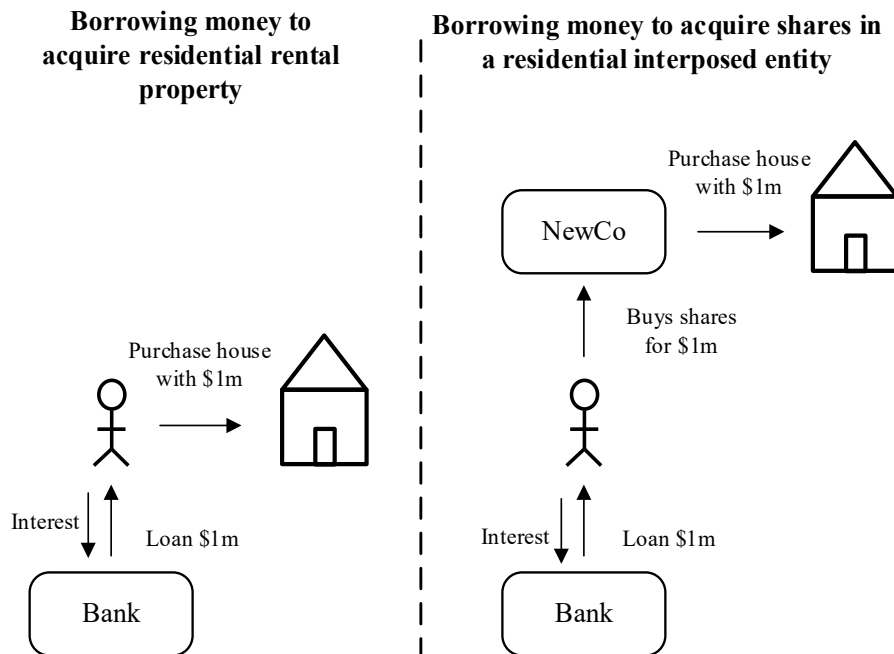
- 11.2 A taxpayer is generally allowed a deduction for interest expenditure on a loan that is used to acquire an ownership interest in an entity if the taxpayer derives assessable income from holding that interest. For example, if a taxpayer borrows to buy a share in a company that pays dividends, interest expenditure on that loan will be deductible.
- 11.3 In the absence of interposed entity rules, a taxpayer who borrows money to acquire an interest in an entity that owns residential investment property would be able to claim a deduction for interest expenditure on a loan that indirectly funds residential investment property. This is not consistent with the Government's desire to limit interest deductions for all borrowings that fund, directly or indirectly, residential investment property.

⁵² For example, shares in a company.

⁵³ See Income Tax Act 2007, ss EL 16 to EL 19.

Example 41: Interposed entity

Figure 1



- Wilfred borrows \$1m from Bank.
 - He buys a residential rental property for \$1m using the borrowed money.
 - Interest paid to Bank is directly traced to the residential rental property and is subject to interest limitation.
- Wilfred borrows \$1m from Bank.
 - He sets up a company, NewCo, and uses the \$1m borrowings to buy shares issued by NewCo.
 - NewCo buys a residential rental property for \$1m using the share issuance proceeds from Wilfred.
 - Interest Wilfred pays to Bank is traced to acquiring shares rather than residential rental property. Therefore it is not subject to interest limitation without an interposed entity rule.

Proposed interposed entity rules

11.4 The Government proposes to adopt two different interposed entity rules, depending on the type of interposed entity and its “affected assets percentage”:

- close companies and trusts with an affected assets percentage over ten percent will be subject to the proposed approach outlined in paragraphs 11.10 to 11.18; and
- all other interposed entities with an affected assets percentage over 50 percent will be subject to the proposed approach outlined in paragraphs 11.19 to 11.21.

11.5 Where an entity exceeds the relevant affected assets percentage, it will be considered a “residential interposed entity”. Interest expenditure incurred by a taxpayer on a loan to acquire an ownership interest in a residential interposed

entity will be limited. If the relevant affected assets percentage is not exceeded, the taxpayer's interest expenditure will not be limited.

Affected assets percentage

- 11.6 An entity's affected assets percentage will be calculated using the following formula:

$$\frac{\text{value of affected assets}}{\text{value of total assets}} \times 100$$

- 11.7 "Affected assets" would include any residential investment property subject to interest limitation, whether those assets are held directly or indirectly (for example, by a subsidiary company).⁵⁴ It would not include new builds or properties that qualify for the development exemption. This is because the affected assets percentage will determine whether interest is subject to limitation (and, if so, how much of it is), and interest incurred to indirectly acquire new builds and development property should not be subject to limitation. Mixed-use assets, which are dealt with under a separate regime, would be excluded from both "affected assets" and "total assets" in the above formula.
- 11.8 The Government considers that a test based on the value of assets held by the entity is preferable to a test based on another metric, such as turnover. An assets test aligns more closely with the purpose of limiting interest deductions for loans used for residential rental purposes. The residential loss ring-fencing rules also use an assets test to work out if an entity is "residential land-rich",⁵⁵ so taxpayers with residential investment properties may already be familiar with such an approach.
- 11.9 To work out an entity's affected assets percentage, the Government proposes to use the same valuation rules as those suggested for the "residential land-rich" threshold in chapter 3 (see paragraphs 3.15 to 3.16). For land, including any improvements, the value would be the later of its most recent capital or annual value, as set by a local authority, or its acquisition cost (or its market value if acquired from an associate). For depreciable property, the value would be the property's adjusted tax value. As proposed in chapter 3, for all other property, there may be merit in allowing taxpayers to use accounting or tax book values where market value cannot be easily ascertained. Submissions are invited on this proposal.

Close companies and trusts

- 11.10 The Government considers that the 50 percent threshold in the existing interposed entity rules for residential loss ring-fencing would be too high for close companies and trusts. The purpose of the interest limitation proposal is to limit interest deductions where borrowings have directly or indirectly

⁵⁴ In working out the value of affected assets held indirectly, the value of affected assets held by a subsidiary is multiplied by the ownership interest in the subsidiary. For example, if a parent company has a 50% shareholding in a subsidiary that owns a residential rental property worth \$500,000, the parent company will be treated as holding residential rental property of \$250,000.

⁵⁵ Section EL 3.

funded residential investment properties. In principle, this would justify having no threshold at all. However, as the interposed entity rule creates compliance costs, a *de minimis* threshold of ten percent is proposed. If a close company or trust’s affected assets percentage exceeds ten percent at any time during an income year, it will be a subject to the interposed entity rules for that income year.

11.11 The existing interposed entity rules for residential loss ring-fencing attribute a portion of the entity’s net residential income to the taxpayer⁵⁶ and subject a portion of the taxpayer’s interest expenditure to ring-fencing.⁵⁷ The Government proposes to adopt the general apportionment approach used in those rules, with some modifications, for close companies and trusts.

11.12 The proposed approach where a taxpayer borrows to acquire an ownership interest in a close company or trust is to deny the taxpayer a deduction for a portion of their interest expenditure. The amount denied would be calculated by the following formula:

$$\frac{\text{interest on amount borrowed to acquire ownership interest}}{\text{entity's affected assets percentage}} \times \text{entity's affected assets percentage}$$

Example 42: Interposed close company rule

On 1 April 2023, Satoshi borrows \$800,000 from his bank at a 5% interest rate. He incorporates a company, NewCo, and uses the borrowed money to subscribe for 100 shares in NewCo. NewCo uses the share issue proceeds to purchase a non-new build residential rental property for \$300,000 and a commercial property for \$500,000.

NewCo’s affected assets percentage is 37.5%. NewCo is above the 10% *de minimis* threshold for close companies.

Satoshi’s interest expense for the 2023–24 income year is \$40,000. The amount of interest denied is \$15,000 (being 37.5% x \$40,000). The remaining \$25,000 of interest expenditure remains deductible.

11.13 This proposed approach is a departure from the full “tracing” approach adopted for interest limitation more generally. Under this proposed approach, tracing is applied as an initial step, as borrowed funds are traced to the acquisition of an interest in an entity that owns affected assets. However, it is not a full tracing approach as it does not require a taxpayer to trace borrowed funds “through” an entity to a particular use or asset. The reason for this is, if the taxpayer does not control the entity, they may find it difficult to obtain the information required to undertake tracing. At the same time, the Government does not propose to limit these rules to taxpayers who control the entity. Economically, a taxpayer who has borrowed to acquire an interest in an entity that owns affected assets has still borrowed to acquire an indirect interest in affected assets, even if they do not control the entity.

⁵⁶ Sections EL 16(2) and EL 17(3).

⁵⁷ Sections EL 16(2) and EL 17(1).

Apportionment calculation

- 11.14 The interposed entity rule applies an apportionment calculation based on the entity's affected assets percentage to work out how much of a taxpayer's interest expenditure is subject to limitation. A key issue is whether the apportionment calculation is done on a daily basis, or less frequently (for example, monthly, quarterly or annually).
- 11.15 If the apportionment calculation is done on an infrequent basis, the interposed entity rules could potentially be circumvented by transactions made shortly before and after the calculations are done. For example, if the calculation is done on a yearly basis, an entity may enter into an arrangement to acquire a non-residential asset with a value greater than the value of the entity's affected assets shortly before the end of the income year (when the calculation is done), and then dispose of that non-residential asset at the start of the next income year.
- 11.16 A daily calculation is more accurate and much harder to manipulate, as shown in Example 43. However, it is potentially more complex than a quarterly or annual calculation. Many closely held entities only own a few residential investment properties, which they hold for long periods. In such cases, the entity's assets will not change in most years, so in most years a more frequent calculation would not be much more complex than an annual calculation. Note that a "daily calculation" does not mean that taxpayers would have to do calculations daily, but merely that the calculation done is daily.

Example 43: Interposed entity rule – apportionment calculation

Assume Tiana has a 31 March balance date. On 1 April 2023, Tiana borrows \$800,000 from the bank at a 5% interest rate (Loan 1). She incorporates a company, NewCo, and uses the borrowed money to subscribe for 100 shares in NewCo. NewCo uses the share issue proceeds to purchase a non-new build residential rental property for \$800,000.

On 1 October 2023, NewCo purchases business premises for \$400,000. It funds the purchase by issuing 80 shares to Tiana for \$400,000. She borrows the \$400,000 from the bank at an interest rate of 5% (Loan 2).

Figures shown in this example have been rounded to two decimal places where applicable, but unrounded figures were used in the actual calculations.

Annual apportionment calculation at end of year

NewCo's affected assets percentage is 66.67% at the end of the income year. Tiana incurred total interest expenditure of \$50,000 on Loan 1 and Loan 2 during the income year.

With an annual calculation, \$33,333 (66.67%) of Tiana's total interest expenditure would be subject to limitation.

Daily apportionment calculation

A daily apportionment calculation takes into account the fact that Tiana's \$800,000 loan indirectly funded the residential rental property for the entire income year, whereas her \$400,000 loan indirectly funded the business premises for only six months.

Tiana incurs interest of \$40,000 on Loan 1 during the income year or \$109.29 per day from 1 April 2023 to 31 March 2024. She incurs interest of \$10,000 on Loan 2 or \$54.64 per day from 1 October 2023 to 31 March 2024.

On each day from 1 April 2023 to 30 September 2023, NewCo's affected assets percentage is 100%. For all of this period, Tiana's daily interest expenditure (of \$109.29) will be subject to limitation.

On each day from 1 October 2023 to 31 March 2024, NewCo's affected assets percentage is 66.67% and Tiana's total daily interest expenditure is $\$109.29 + \$54.64 = \$163.93$. For all of this period, 66.67% of Tiana's daily interest expenditure (\$109.29) will be subject to limitation.

The net result is equivalent to fully limiting the interest on Loan 1 which was used to acquire the residential rental, but not on Loan 2, which was used to acquire business premises. (We note that in other, more complex, cases the amounts of interest limited will not directly match up with how funds were used.)

- 11.17 As Example 43 shows, an annual calculation may over-limit or under-limit interest deductions. In Example 43, Tiana incurred \$40,000 of interest on a loan that indirectly funded a residential investment property and incurred \$10,000 of interest on a loan that indirectly funded business premises. Limiting interest deductions of \$33,333 in effect under-limits interest on Loan 1, which indirectly funded the purchase of residential investment property.
- 11.18 Submissions are invited on what frequency would be workable for the apportionment calculation, bearing in mind that infrequent calculations would be more likely to require a specific anti-avoidance rule. A similar anti-avoidance rule applies to increases or decreases in value that have the purpose or effect of defeating the thin capitalisation rules.⁵⁸

Other residential interposed entities

- 11.19 The interposed entity rules for residential loss ring-fencing apply only to close companies and other closely held entities such as trusts, because the loss ring-fencing rules mostly affect individuals, trusts and close companies. The interest limitation proposal, however, is more far-reaching and also affects widely-held companies that are residential investment property-rich: see chapter 3. The interposed entity rules for interest limitation should therefore also apply to widely-held entities that have a high affected assets percentage.
- 11.20 The Government proposes that an entity whose affected assets percentage exceeds 50 percent at any point in an income year be treated as a "residential interposed entity" if it is not a close company or trust. The affected assets percentage would be calculated using the same rules described in paragraphs 11.6 to 11.9.
- 11.21 Where a taxpayer borrows to acquire an interest in a residential interposed entity that is not a close company or trust, they should be treated as borrowing to acquire affected assets and all of their interest deductions should be subject to limitation. This is simpler than the apportionment approach proposed above for close companies and trusts, as the complexities involved in apportioning are much greater for widely-held companies. At the same time, a higher affected asset percentage (50 percent) than the one for close companies and

⁵⁸ Section GB 51B.

trusts (ten percent) is proposed to ensure that taxpayers borrowing to acquire shares in entities with modest amounts of affected assets are not subject to full interest limitation.

Example 44: Widely-held residential interposed entity

Tama borrows \$10,000 from his bank at a 5% interest rate. He buys shares in a widely-held company, PropertyCo. PropertyCo's assets by value consist of 35% new builds, 60% other residential investment properties (old builds), and 5% cash and bonds.

PropertyCo's affected assets percentage is 60%. As this exceeds 50%, Tama will not be allowed deductions for any of his interest expenditure.

Look-through companies and partnerships

- 11.22 There is a question about whether interposed entity rules need to apply to look-through companies (LTCs) and partnerships, since these are already transparent for tax purposes. Look-through companies were included in the interposed entity rule for residential loss ring-fencing because of the following concern: a taxpayer may borrow to acquire shares in an LTC, and the LTC may then acquire a residential investment property. While the taxpayer would be treated for tax purposes as holding the residential investment property in proportion to their effective look-through interest, there was a concern that the interest on the taxpayer's loan could arguably not be treated as incurred in acquiring the residential property, but as incurred in acquiring the LTC shares. A similar argument may be employed for partnerships. Look-through companies and partnerships were included under the interposed entity rule to avoid such arguments.
- 11.23 It is not appropriate to extend the interposed entity rule for interest limitation to LTCs and partnerships, as this could give rise to inconsistent tax outcomes. The transparent nature of LTCs and partnerships in effect require a full tracing approach, whereas the proposed interposed entity rule would not.
- 11.24 To address the concern outlined at paragraph 11.22, a specific provision is proposed to clarify that, if a taxpayer borrows to acquire a look-through interest or a partnership share, the borrowing is treated as having been used to acquire the assets of the LTC or partnership, rather than the look-through interest or partnership share. This approach would be more consistent with the transparent nature of LTCs and partnerships.

Existing interposed entities

- 11.25 For simplicity, the Government considers that interest limitation should apply, with effect from 1 October 2021, to taxpayers with existing loans used to acquire an ownership interest in an interposed entity subject to the rules proposed above. In other words, phasing will not apply to any interest deductions limited under either of the interposed entity approaches proposed above.

Tax treatment when taxpayer no longer holds interest in interposed entity

- 11.26 A taxpayer may cease to hold an interest in an entity that owns affected assets in one of two ways. The taxpayer may dispose of their interest in the entity or the entity may dispose of its affected assets.
- 11.27 For simplicity, it is proposed that neither of these events will result in a taxpayer's previously denied interest deductions being "allowed back", regardless of whether the disposal is taxed and regardless of the decisions reached in relation to chapter 5. The interposed entity rules are primarily aimed at maintaining integrity and taxpayers will not have to apply the rules if the borrowing is done by the same entity that holds the affected assets.

On-lending by taxpayer to interposed entity

- 11.28 Instead of borrowing to acquire an interest in an entity that owns affected assets, a taxpayer may borrow money to on-lend to an entity that owns affected assets. In this case, the entity will be subject to interest limitation if it used the funds to acquire affected assets, and the taxpayer's interest deduction may not need to be limited.

Example 45: On-lending to an interposed entity

Zeean is the sole shareholder of LandCo. She borrows \$800,000 from her bank at a 5% interest rate and on-lends the money to LandCo, also at a 5% interest rate. LandCo uses the money to acquire a residential investment property. Zeean does not directly own any affected assets.

LandCo's interest expenditure on the loan from Zeean would be subject to limitation because LandCo used the borrowed funds to acquire a residential investment property.

The interest expenditure incurred by Zeean on her loan from the bank would not be subject to limitation under the proposed interposed entity rules. This is because she used the borrowed funds to derive interest income from LandCo, rather than to acquire an ownership interest in LandCo.

We note that if Zeean on-lent the borrowed money to LandCo at an interest rate less than the rate she borrowed at, the amount of interest limited (for LandCo) will be less than the amount of interest incurred by Zeean. Such an arrangement would undermine the integrity of the interest limitation rules.

- 11.29 The Government is considering a specific anti-avoidance rule to capture situations where a taxpayer borrows money at a given interest rate (for example, 5%) and on-lends the money to an entity at a lower interest rate (for example, 2%). The rule would apply if:
- the taxpayer has an ownership interest in the entity; and
 - the entity's affected assets percentage exceeds the *de minimis* threshold.
- 11.30 If the specific anti-avoidance rule applied, an amount of the taxpayer's interest expenditure would be subject to limitation, based on the difference between the taxpayer's borrowing interest rate and on-lending interest rate.

Feedback on interposed entities

Questions for submitters

- What do you think of the interposed entity rules proposed above?
- In your experience, how common are interposed entities in the residential investment property context?
- What are some of the commercial reasons why, for close companies, taxpayers may prefer to have their borrowing at the shareholder level instead of the entity level?
- Do you prefer to use accounting or tax book values for calculating the affected assets percentage for assets other than land, improvements and depreciable property? Why?
- What is your preferred frequency for the apportionment calculation for interposed entities that are close companies or trusts - daily, monthly, quarterly, annually?
- Do you agree that the proposed interposed entity rules should not be applied to LTCs or partnerships?
- Are there any commercial reasons why a taxpayer might borrow funds and on-lend them to an interposed company at a lower interest rate?

Chapter 12

Implications for the rental loss ring-fencing rules

Introduction

- 12.1 The rules governing the ring-fencing of residential losses were introduced in 2018 to reduce the tax benefits for property investors compared to owner-occupiers.
- 12.2 The rental loss ring-fencing (RLR) rules were introduced to prevent investors from deducting expenditure relating to their loss-making residential investment properties from their other income (for example, salary or wages, or business income), to reduce their tax liability. This is done by allocating deductions for residential land to the next income year, to the extent those deductions exceed income from residential land and meet general continuity requirements. The introduction of these rules was aimed at making the tax system fairer and improving housing affordability for owner-occupiers by levelling the playing field between property investors and home buyers.
- 12.3 The existing RLR rules already restrict the ability of rental property investors to derive tax benefits from investing in rental properties. The interest limitation rules will further reduce tax benefits from investing in rental property. There is likely to be significant interplay between the proposed interest limitation rules and the existing RLR rules.
- 12.4 This chapter explores how the RLR rules overlap with the proposed interest limitation rules and proposed exemptions, and the technical issues that are likely to arise. The Government would like to receive submissions on the issues highlighted in this chapter and any other issues that should be addressed.

How rental loss ring-fencing rules apply to residential property generally

- 12.5 The default position is that the RLR rules apply on a portfolio basis, meaning investors calculate their overall profit or loss across their portfolio of residential properties. The income from all properties in the portfolio is offset by deductions from all those properties
- 12.6 However, investors can elect to apply the rules on a property-by-property basis if they wish. When using a property-by-property approach, each property is looked at separately and deductions for one are not able to offset income from another. If a property-by-property approach is taken, and it transpires that the sale of the property is taxed, any remaining excess deductions are released from the RLR rules and used against the taxpayer's income from other sources.
- 12.7 The rental loss ring-fencing rules do not apply where the property will be taxable on sale; for example, if the land was acquired for the purposes of a business relating to land under section CB 7. Where the property is taxable on sale under section CB 7, the exemption will automatically apply. Where the

land is taxable on sale for any other reason, Inland Revenue must be notified that it is held on revenue account for the exemption to be applied.

- 12.8 Only land that will definitely be taxed on sale will be excluded, not land that may be taxed on sale if certain contingencies occur (for example, being sold within a particular time period – such as under the bright-line test). Where land will be taxed on sale, there is not the same concern about some of the deductible expenses relating to untaxed gains, as all the economic income from the investment will be taxed.
- 12.9 Ring-fenced deductions are released if a property ends up being taxed on sale and the taxpayer has:
- applied the rules on a property-by-property basis; or
 - applied the rules on a portfolio basis and all of the properties within the portfolio were sold and were subject to tax on sale.
- 12.10 If the ring-fenced deductions exceed what is necessary to reduce the taxable gain on the sale to nil, the remainder of the deductions would be released and able to be offset against other income. This represents a deferral of interest deductibility, as well as other deductible expenses that made up the ring-fenced deductions.
- 12.11 Excess deductions would remain ring-fenced after a non-taxable sale of property, or after divestment of a portfolio where not all the properties that were in the portfolio were taxed on sale. A taxpayer can choose to treat those ring-fenced deductions as relating to another property. However, if this is done, the deductions would “taint” the property (and any portfolio it is part of), such that any excess deductions on a taxable sale of that property or taxable divestment of the portfolio would not be released. The excess deductions would still be able to be used to reduce the taxable gain to nil, but if there are excess deductions beyond that they would remain ring-fenced.
- 12.12 Ring-fenced deductions can be transferred between companies in a wholly-owned group. Transferred deductions remain ring-fenced in this instance. Any remaining deductions would be carried forward and would remain ring-fenced.

General interface issues

- 12.13 There are aspects of the proposed interest deductibility settings that diverge from the rental loss ringfencing rules. This section will highlight these differences and explore the extent to which these two regimes should be aligned. Aligning both regimes ensures that the RLR rules are not undermined by any potential exemptions from interest deductibility.
- 12.14 The starting approach to address the interplay between the interest limitation rules and the RLR rules is to determine the order the rules will apply. We consider that the interest limitation rules should apply first to determine whether interest is potentially deductible in an income year.

- 12.15 If the interest is deductible under the interest rules, it will be viewed as expenditure incurred to derive income from the residential investment property and will be subject to the RLR rules. The timing of the deduction may be deferred under those rules (that is, if the taxpayer has an overall rental loss for the year).

Portfolio approach versus a property-by-property approach

- 12.16 The RLR rules can be applied either on a portfolio basis or on a property-by-property basis. This raises the question of whether the interest limitation rules may apply on a portfolio approach or a property-by-property approach.
- 12.17 We consider that it is not practical to operate interest limitation rules on a portfolio approach. Each property may have different characteristics for interest limitation rules. For example, some may qualify for the new build or development exemption, and so be entitled to interest deductions on a current basis. Others may not enjoy such an exemption, and so interest deductions are not allowed on an ongoing basis. Depending on decisions regarding treatment of interest in the year of sale, some amount of interest may become available to deduct in the year of sale. When this occurs, the interest will be subject to the RLR rules in determining if and when the interest is deductible.
- 12.18 The Government considers that, although the interest limitation rules must apply on a property-by-property approach, they may work with the RLR rules regardless of whether the taxpayer is using a portfolio or property-by-property approach. However, how the rules interact may lead to different outcomes in different circumstances.

Exemptions

- 12.19 The RLR rules may not align with some of the exemptions being proposed for the interest limitation provisions. For example, the RLR rules have no equivalent to a new build exemption. If interest is deductible under the interest limitation proposal, it could potentially be denied or deferred under the RLR rules (if the interest deduction results in a net loss for the year).
- 12.20 A way of addressing this is to say the RLR rules do not apply if one of the exemptions for interest limitation (new build or development exemption) applies. However, this may liberalise the taxation of rental property investment in some cases.

Development exemption

- 12.21 The RLR rules have an exemption for property developers, property dealers and builders who fall under section CB 7. They also allow property otherwise held on revenue account to be exempt from the RLR rules if the taxpayer makes a statement on their tax return to Inland Revenue. In practice, this is likely to cover most of the taxpayers covered under the development exemption proposed for the interest limitation rules. However, there may be some differences.

- 12.22 Officials seek submissions on the issues that are raised and whether the regimes should be aligned.

New build exemption

- 12.23 The RLR rules do not provide a specific exemption for a new build. This has the potential to reduce, but not necessarily eliminate, the benefit of the new build exemption.
- 12.24 For example, assume a residential rental property that is a new build earns \$20,000 of net rental income before interest each year, and the interest expense is \$21,000 per year. The new build exemption would allow the \$21,000 of interest expense to potentially be deductible each year. However, the rental loss ring-fencing rule would not allow the net rental income to fall below nil each year. This would reduce the benefit of the new build exemption from a deduction of \$21,000 per year to a deduction of \$20,000 per year.
- 12.25 One option would be to extend the RLR exemption (as with section CB 7) to new builds, in line with the treatment of developers. For example, a taxpayer who qualifies for a new build exemption could indicate on their tax return that they have a qualifying new build, enabling them to be exempt from the RLR rules.
- 12.26 If the new build exemption were to extend to the RLR rules, we consider it should be added to the exclusion in section EL 10, so the income from new builds cannot be additional residential income of a residential portfolio to which they belong.

Sale of property: arbitrage issues

- 12.27 Currently, properties that are taxed on sale due to being purchased for the purpose of a business dealing in land are not subject to the rental loss ring-fencing rules and so losses can be deducted in the years incurred. Other property that is not taxed on sale under another of the land sales rules must be notified to the Commissioner as land held on revenue account for this exemption to apply. Should such property not be notified to the Commissioner, deductions are allowed in the year of sale. Under the interest limitation proposal, deductions are not allowed on a current basis. This may create some mismatch in timing of the rules.
- 12.28 The bright-line sale rule has an anti-arbitrage provision that says a bright-line loss may not be able to be deducted immediately, but it may be grouped against other real property gains in the same or later income years. The RLR rules provide that all rental losses for the property are immediately deductible when the property is sold on revenue account. However, losses remain restricted if it is sold on capital account.
- 12.29 No special rule is provided for bright-line revenue account sales, so it appears that there is an arbitrage possibility to sell bright-line property on revenue account under the current law. This will be increased if we also allow deferred interest to be deducted when the property is sold on revenue account.

Example 46 – effect of residential loss ring-fencing on deferred interest deduction

Property B has \$20,000 in deductible interest expense each year. Assume net rental income before interest is also \$20,000 per year. After nine years, \$180,000 of interest has been ring-fenced and carried forward. Before the interest limitation rules this would all have been deductible over the nine-year period since the property did not have a net loss. Under interest limitation, at the time of sale, a \$180,000 interest deduction becomes available. The rental loss ring-fencing rules would deny a deduction for \$160,000 of this. This increases the incentive for a taxpayer to sell a property on revenue account (even including some cases where the property is sold for a net gain if the released interest deduction exceeds the amount of the gain), resulting in more than would be deductible in the year of sale than in the current rules.

- 12.30 Given the example, it may be worth implementing an anti-arbitrage rule for the deferred interest on bright-line revenue account sales, in a similar way to what is done with bright-line losses. It is also worth considering whether to include other RLR losses in an anti-arbitrage rule. As discussed in the chapter on revenue account property sales, if the bright-line anti-arbitrage rule is extended to section CB 6 property, a rental loss ring-fencing anti-arbitrage rule could apply to those sales as well as bright-line sales.
- 12.31 Numerous combinations of rules are possible here. Issues that arise include:
- when and if deferred interest is deductible;
 - whether accumulated losses are released on sale of a property;
 - whether the bright-line anti-arbitrage rule or the loss ring-fencing rule is applied, or both; and
 - how deferred interest enters into the loss ring-fencing calculation.
- 12.32 The treatment may depend upon whether the property is on revenue or capital account. Some of this was discussed in chapter 5.
- 12.33 The table at the end of the chapter illustrates how anti-arbitrage rules (including the current bright-line anti-arbitrage rule) may be incorporated into loss ring-fencing under the property disposal scenarios discussed in chapter 5. It would also be possible to prevent arbitrage by keeping the RLR rules as they are and providing that the deferred interest amount in the year of sale is treated as an additional cost for purpose of the section EL 20 bright-line anti-arbitrage rule.
- 12.34 The Government seeks submissions on the issues raised with the interaction of the interest limitation rules and the residential loss ring-fencing rules.

Questions for submitters

Below are several questions the Government would specifically like feedback on from submitters:

- How should the interest limitation rules be aligned with the loss ring-fencing rules?
- Is the proposed approach of applying the interest limitation rules to establish deductible expenditure and then applying the RLR rules to this deductible expenditure an effective means of addressing this?
- Are there other interface issues between the rules that we have not addressed?
- How should we integrate interest limitation, ring-fencing, and bright-line anti-arbitrage rules?

Table 4: Current and proposed treatment of interest expenses under residential loss ring-fencing if some anti-arbitrage is incorporated into residential loss ring-fencing

	Revenue account	Capital account
Current law		
As interest is incurred	Interest deductible subject to RLR	Interest deductible subject to RLR
In year of sale	<ul style="list-style-type: none"> • Gain is taxable and adds to residential income to use against current and carryforward rental loss. • Loss is subject to bright-line (BL) anti-avoidance rule, deductible only against other real property gains in the current or future years; • Loss is not taken into account as loss against residential income; • Whether a gain or loss, all suspended or carried forward deductions are unfenced and deductible against other income (unless the property sold was in a portfolio and it was not the last property in the portfolio, in which case excess deductions remain in the portfolio). 	<ul style="list-style-type: none"> • Gain or loss is not taxable or deductible; • Excess rental losses carried forward are not unfenced and remain in the portfolio or may be transferred to another property or portfolio if the property sold was the last property in the portfolio.
Proposed law		
As interest is incurred	Interest is not deductible	Interest is not deductible

	Revenue account	Capital account
In year of sale	<p>Option A⁵⁹</p> <ul style="list-style-type: none"> • If gain, gain is taxable and adds to residential income to use against current and carryforward rental loss. • If loss, loss is subject to BL anti-avoidance rule, deductible only against other real property gains in the current or future years; • Loss is not taken into account as loss against residential income; • Whether a gain or loss, interest associated with the property is not deductible; • All suspended or carried forward deductions are unfenced and deductible against other income (unless the property sold was in a portfolio and it was not the last property in the portfolio, in which case excess deductions remain in the portfolio). 	<p>Option E</p> <ul style="list-style-type: none"> • Gain or loss is not taxable or deductible; • Interest associated with the property is not deductible; • Excess rental deductions carried forward are not unfenced and remain in the portfolio or may be transferred to another property or portfolio if the property sold was the last property in the portfolio.
	<p>Option B</p> <ul style="list-style-type: none"> • If gain, gain is taxable and adds to residential income to use against current and carryforward rental loss. • If loss, loss is subject to BL anti-avoidance rule, deductible only against other real property gains in the current or future years; • Loss is not taken into account as loss against residential income; • All current and deferred interest is deductible in the year of sale; • All suspended or carried forward deductions are unfenced and deductible against other income (unless the property sold was in a portfolio and it was not the last property in the portfolio, in which case excess deductions remain in the portfolio). 	<p>Option F⁶⁰</p> <ul style="list-style-type: none"> • Gain or loss is not taxable or deductible; • Interest, to the extent of an untaxed gain (if any), is not deductible; • Interest in excess of the non-deductible amount associated with the property is deductible and treated as an expense incurred in earning residential income for RLR purposes; • Excess rental deductions carried forward are not unfenced and remain in the portfolio, or may be transferred to another property or portfolio if the property sold was the last property in the portfolio.

⁵⁹ Options refer to options on taxation of disposals discussed in chapter 4.

⁶⁰ The discussion assumes Option F incorporates anti-arbitrage restrictions as discussed in chapter 4.

	Revenue account	Capital account
	<p>Option C</p> <ul style="list-style-type: none"> • If gain, gain is taxable and adds to residential income to use against current and carryforward rental loss. • If loss, loss is subject to BL anti-avoidance rule, deductible only against other real property gains in the current or future years; • Loss is not taken into account as loss against residential income; • Current and deferred interest is deductible in the year of sale to the extent of gain on sale; additional interest is not deductible; • All suspended or carried forward deductions are unfenced and deductible against other income (unless the property sold was in a portfolio and it was not the last property in the portfolio, in which case excess deductions remain in the portfolio). 	

	Revenue account	Capital account
	<p>Option D</p> <ul style="list-style-type: none"> • If gain, gain is taxable and adds to residential income to use against current and carryforward rental loss. • If loss, loss is not subject to BL anti-avoidance rule; • Instead, loss is taken into account as loss against residential income and becomes subject to RLR restriction; • Interest associated with the property is deductible and treated as an expense incurred in earning residential income for RLR purposes; • Unlike current law, excess rental deductions associated with property (after including the freed-up interest expense) are not unfenced and remain part of RLR carry-forward for the portfolio (or transferred to another property or portfolio if it was the last property in the portfolio). 	

Chapter 13

Interest limitation and mixed-use residential property

Introduction

- 13.1 This chapter considers the application of the interest limitation proposal to residential property that is partly used to earn assessable income and partly used for private purposes. Common examples are baches or second homes that are rented out on a short-term basis if possible when not used by their owners. This chapter refers to these as mixed-use properties and the term includes properties that are subject to the existing mixed-use asset (MUA) rules.

Current law on interest deductions for mixed use properties

- 13.2 The determination of what interest relates to a mixed-use property, and of how much of that interest is deductible, is generally made under the MUA rules in subpart DG of the Act. However, not all mixed-use properties are subject to the MUA rules.
- 13.3 The MUA rules apply where a property is sometimes used privately and sometimes used to derive income but is also unused for at least 62 days in an income year. The rules ensure that an appropriate proportion of the expenses that relate to the “unused” period is deductible.
- 13.4 The MUA rules do not apply to property that is:
- **not used privately at all** (instead being either rented on a short-term basis or left vacant) (section DG 3(1)(a)). In this case, interest is generally treated as related to the property under tracing principles, and interest allocated on a per diem basis such that:
 - rental days will generally be deductible
 - vacant days will depend on the context; for example, whether the property was acquired for eventual private use, or for the purpose of resale;
 - **vacant for less than 62 days in an income year** (section DG 3(1)(b)). Tax treatment will generally be determined by a per diem allocation;
 - **held by a company that is not a close company** (section DG 3(3)). Companies have an automatic interest deduction. It would seem unlikely for a company that is not a close company to own residential property that is not used for the exclusive purpose of the company’s business; for example, as a development property, or for the purpose of providing accommodation to employees. Such property would not be mixed-use property.
- 13.5 Under subpart DG, interest is generally related to MUAs under tracing principles. However, there is a special rule for interest incurred by a close company that owns a MUA. Section DG 11 allocates any debt of the company

to the MUA up to the amount of the value of the MUA and treats interest on that debt as related to the asset. This is often referred to as a stacking rule, since it stacks the debt first against the MUA.

13.6 The MUA rules can also treat interest incurred by:

- a company in the same group as a close company that owns a MUA (section DG 12); and
- a direct or indirect shareholder in a close company that owns a MUA (sections DG 13 and DG 14)

as related to the MUA (and thus only partially deductible), if the debt allocated to the MUA by the close company owner is less than the value of the MUA. This is a form of “interposed entity” rule.

13.7 Under subpart DG, interest expenditure related to a MUA is deductible in the year it is incurred to the extent of the ratio of income-earning days⁶¹/all days of actual use (that is, excluding vacant days) (sections DG 5 and DG 9).

13.8 MUAs are not subject to the residential loss ring-fencing rules (section EL 12). Instead, if income derived by the owner from non-associates is less than 2% of the value of the property, expenses in excess of that income are not deductible in the year incurred (section DG 16). These non-deductible expenses may be deductible in a later year in which income exceeds expenses (section DG 17). This is known as quarantining. If the quarantined asset in question is owned by a close company, interest expenditure incurred by group companies and shareholders can also be quarantined (sections DG 18 and DG 19).

Proposals

Determining what interest relates to mixed-use residential property

Property not owned by a close company

13.9 For mixed-use residential property owned by a person who is not a close company, the tracing rules considered in chapter 4 will apply to determine what interest relates to that property. If the interest is not eligible for phasing, and the property is not a new build, the interest will not be deductible. Otherwise, the deductible portion of the interest must be calculated using the appropriate per diem formula under existing law, and a deduction will then be allowed for either all of that interest (if the property is a new build) or part of it under phasing. This is all very similar to the rules applying to property that is rented out all the time.

⁶¹ For completeness, we note that section CW 8B treats as exempt income some income earned from the use of a MUA that would normally be taxable. This in turn means expenses incurred to earn that exempt income are non-deductible.

- 13.10 The current quarantining rule would continue to apply to limit current year deductions on mixed-use residential property subject to the MUA rules, though it would not apply to non-deductible interest.
- 13.11 Any allowance of interest deductions when the relevant property is sold (as discussed in chapter 5) should also be able to be applied to a sale of mixed-use residential property.

MUA property owned by a close company

- 13.12 It would not make sense to apply the tracing rules to residential property that is a MUA held by a close company, when section DG 11 already has its own regime for relating interest expense to MUAs. Section DG 11 should continue to apply in this case. This will have implications for the amount of interest deductions denied. It also creates a distinction between residential rental property and other MUAs, which in turn creates a need for a rule to determine how interest expense is allocated. We propose that it is allocated to MUAs pro rata.

Example 47 – Close company with two MUAs, one of which is residential property – allocation of debt

HB Ltd is a close company that owns a holiday home and a boat, both of which are subject to the MUA rules. The holiday home has a rateable value of \$180,000 and the boat has a depreciated value of \$60,000. The company has debt of \$150,000 with associated interest expenditure of \$8,000. Under the MUA allocation rule, all of this debt and interest will be allocated to the holiday home and the boat. The rule does not currently contain an ordering rule, but we suggest that the debt be allocated on a pro rata basis, that is, 18/24ths (or \$112,500) and 6/24ths (or \$37,500), respectively. A deduction will then be denied for the \$6,000 allocated to holiday home, and allowed in part for the portion allocated to the boat (\$2,000) in accordance with the formula in section DG 11(3B).

- 13.13 If a close company with a MUA has both loans that existed before 27 March 2021 and loans taken out afterwards some approach will be needed to relate those loans to the different assets. It would not seem to make sense to take a tracing approach. Possibly the loans could be allocated pro rata, or some order could be provided for. For example, the debt allocated to the MUAs could be treated as the oldest debt. This could be left to be dealt with as an administrative matter, or a rule could be legislated. Submissions are sought on which option is preferable, and what a good rule would be.

Close company holding MUA and non-MUA residential property

- 13.14 A close company could own residential property (or other property) that is a MUA and some residential property that is not a MUA (for example, property held for full-time rental) but is subject to denial of interest deductions.
- 13.15 In this case, it will not make sense to apply:
- the MUA stacking rule to relate interest to MUAs; and
 - the general tracing rule to relate interest to non-MUA residential property.

- 13.16 Such an approach could result in the same interest being allocated to two different items of residential property. This is already an issue where a close company holds a MUA and a property subject to the residential loss ring-fencing rule. On the basis that it is not currently addressed legislatively, it may be that no response is required in this case also. Submissions are sought on how likely it would be for a company to hold both MUAs and non-MUA residential property.
- 13.17 There is a way to address this issue of a close company holding a MUA and non-MUA residential rental property subject to some form of interest deduction limitation. Section DG 11 could not apply to relate to the MUA any debt allocated on a tracing basis to non-MUA, non-new build residential property. Another possibility could be that interest expense is allocated to the non-MUA residential property as well as the MUA on a pro rata basis, as in Example 47.
- 13.18 When a close company with a MUA holds non-MUA residential property that is not subject to any form of interest deduction limitation, no allocation issue arises.

Example 48 – close company with non-MUA residential property and a MUA – allocation of debt

RB Ltd is a close company that owns a long-term rental property not eligible for the NBE and a boat. The boat is subject to the MUA rules. The rental property has a rateable value of \$180,000 and the boat has a depreciated value of \$60,000. The company has debt of \$150,000 with associated interest expenditure of \$8,000. \$50,000 of this debt was incurred to acquire the property and meet expenses related to it, and the remaining \$100,000 has funded the boat and miscellaneous expenses relating to the boat.

Under the first approach referred to above, interest on \$50,000 (assume \$2,667) is related to the rental property on tracing principles and is non-deductible, and \$60,000 of the remaining \$100,000 of debt is related to the boat under the stacking rule in section DG 11. Interest on this debt (assume \$3,200) is partially deductible under the formula in section DG 11(3B). Interest on the remaining \$40,000 of debt (assume \$2,133) is fully deductible.

Under the second approach, the \$8,000 of interest is treated the same way as in Example 47, that is, it is allocated to the rental property and the boat on the basis of their relative values. This will result in more interest being allocated to the rental property, and so being non-deductible.

MUA property owned by a close company: interposed entity and group company rules

- 13.19 Where residential property is a MUA owned by a close company, we propose that the interposed entity rules considered in chapter 11 should not apply. Instead the rules that already apply to relate group company or shareholder level debt to the MUA in some cases (sections DG 12 to DG 14) should continue to apply.

Example 49 – MUA interposed entity rule applied by a corporate shareholder in a close company with a residential property MUA

HB Holdings Ltd owns shares in a number of subsidiaries, including 100% of HB Ltd in Example 47. HB Holdings Ltd has debt of \$1 million, and associated interest expense of \$50,000. HB Holdings chooses to take into its own tax return the full amount of the adjustment required by section DG 12, as a consequence of HB Ltd having a net asset balance of \$90,000 (\$240,000 – \$150,000 - *see* section DG 11(7)).

Under current law, HB Holdings would split its interest expenditure into two amounts. First it would determine the “reduced amount”, which would be its interest expense x the net asset balance/its total debt, or \$50,000 x \$90,000/\$1,000,000, which is \$4,500. If the holiday home is not eligible for the NBE, a deduction would be denied for \$3,375 of this interest (because it is attributable to the holiday home owned by HB Ltd), and allowed in part for the \$1,625 attributable to the boat. If the holiday home is eligible for the NBE, a portion of the amount allocated to the holiday home will be deductible. HB Holdings will be allowed a deduction for the remaining \$44,000 of its interest, under section DG 12(7C).

Example 50 – MUA interposed entity rule applied by a trust shareholder in a MUA with a residential property MUA

Suppose that instead of being owned by HB Holdings, HB Ltd in Example 47 is owned by the trustees of a family trust called The Hinemoa Trust. The Hinemoa Trust also has debt of \$1 million and interest expense of \$50,000, but only \$20,000 of its debt was incurred to acquire the shares in HB Ltd. Under section DG 14, the Trust must allocate the \$1,000 of interest attributable to the debt to the MUAs. A deduction would be denied for \$750 of the interest allocated to the property, and allowed in part for \$250 of the interest allocated to the boat.

Concurrent application of different interposed entity rules

- 13.20 If a company that is not a close company holds a residential property, or a close company holds a residential property that is not a MUA, the interposed entity rules in chapter 11, rather than sections DG 12 to DG 14, will *prima facie* determine the extent to which any interest incurred by a shareholder in that company is treated as related to the property.
- 13.21 Again, the co-existence of different rules for allocating debt to residential property (in this case, property held by an interposed entity) is at least potentially problematic.
- 13.22 Firstly, if the non-MUA property is held by a close company that also owns a MUA, it may not be possible for a shareholder of that company (whether a natural person or a company) to apply sensibly both the proposed interposed entity rule and sections DG 12 to DG 14. This may already be an issue in terms of the interaction of sections DG 12 to DG 14 and EL 16 and EL 17 (the interposed entity rule for purposes of the rental loss ring-fencing rule).
- 13.23 Secondly, it may be that the group company or shareholder is required to or chooses to apply both sections DG 12 to DG 14 and the interposed entity rules in chapter 11 with respect to different companies. This would not be problematic for a shareholder who is a natural person, since that person will apply tracing to both interests. For a shareholder who is a company, the

application of stacking to determine the amount of interest allocated to the interest in the company holding the MUA, and tracing to determine the amount of interest allocated to the company holding the non-MUA residential property, may be problematic.

Quarantining

- 13.24 Quarantining would continue to apply to residential property that is a MUA, though, given the reduced amount of deductible interest, the amount of expenditure for which a current year deduction is not allowed under quarantining will be reduced.

Questions for submitters

Below are several questions the Government would specifically like feedback on from submitters:

- How commonly are residential property MUAs held in close companies?
- How commonly are residential property and other MUAs held in the same close company?
- How do companies currently deal with the conflict between the MUA interposed entity rule and the RLR interposed entity rule, where they own both an interest in a close company with a MUA and a close company with a residential property subject to the RLR rule?

Chapter 14

Administration

Introduction

- 14.1 This chapter considers the administrative aspects of the Government's proposal to limit interest deductions for residential investment properties and aspects of the recent extension of the bright-line test from five to ten years. It outlines the proposed approach to administering these changes in terms of making the rules work, ensuring compliance and informing Government about the effectiveness of the changes and whether they are appropriately targeted.

Information currently available to Inland Revenue

- 14.2 Inland Revenue receives data in relation to residential rental properties through different channels. Taxpayers provide information to Inland Revenue directly (in some returns or forms) or through Land Information New Zealand (LINZ) in the Land Transfer Tax Statement as part of a property transfer. Inland Revenue receives additional property data from third parties such as LINZ and commercial providers. However, there are currently limited reporting requirements concerning interest expenses incurred in relation to residential rental properties.
- 14.3 Taxpayers earning income that is not taxed at source (such as rental income) are required to include this income in their income tax return. However, income tax returns do not currently require taxpayers to specify information relating to interest expense incurred on loans relating to residential rental properties.
- 14.4 Individuals with rental income are prompted to complete a rental income schedule (IR3R), which is provided alongside the IR3 income tax return form. This form is not compulsory but records relevant information for working out profit from rental activity, including the amount of interest expense incurred by the taxpayer in relation to the rental activity.
- 14.5 Additionally, taxpayers who are in business are encouraged to complete and file the IR10 form, which collects financial data for primarily statistical purposes. Similar to the IR3R, the IR10 records information about income and expenses that could be related to a rental activity, although (unlike the IR3R) it does not ask for expenses that are specifically related to this type of business - instead, the form simply asks for the business' expenses as per its financial statements.
- 14.6 The current level of information reporting on residential land sales and on income and expenses from residential rental activities poses a number of challenges for the administration of the proposed interest limitation rules and the extended bright-line test:

- It would be difficult to understand whether owners of residential land understand and are complying with their tax obligations, in particular in relation to situations where an exemption from the application of the new rules would apply.
 - It is important for the Government to know how effective the policies are, their revenue impacts and whether they are appropriately targeted. There is currently no comprehensive data available to allow for this.
- 14.7 There are a number of administrative changes that could be considered to address these issues. Inland Revenue could extend or introduce additional (compulsory) reporting requirements for residential rental property owners. This involves a trade-off between better compliance on one hand, and increased compliance and administrative costs on the other. It is also important to consider who the compliance costs will fall on.
- 14.8 Residential rental property owners will need to be able to work out their allowable interest deductions. This means for existing properties they will have to know whether the interest phase-out rules apply (in respect of residential land purchased before 27 March 2021). In relation to residential property purchased on or after 27 March 2021, or for land where a code compliance certificate (CCC) for a new build is issued on or after this date, they will need to determine whether any of the exemptions from the application of the new rules apply (for example, the development and new build exemptions). Accordingly, it may make the most sense for taxpayers to provide the required additional information about whether these exemptions apply.
- 14.9 Consideration is being given to whether it may be necessary to require taxpayers to provide additional information may be necessary to support the administration of the Government's interest limitation proposal and the changes to the bright-line test - for example, the amount of total relevant interest expenses incurred and the amount of interest deducted for tax purposes, or providing evidence that an exemption from interest limitation applies.
- 14.10 Another option would be to simply rely on the existing record keeping rules in the Tax Administration Act 1994, under which taxpayers are required to keep records that are relevant to determining their tax position. These can be requested by Inland Revenue as part of compliance activity, including an audit.
- 14.11 However, having the right data at the right time would enable Inland Revenue to improve its interventions to better assist owners of residential investment properties to get it right from the start. Also, ensuring that Inland Revenue has information that is timely and sufficient for risk-assessing tax positions taken by investment property owners would enable Inland Revenue's compliance actions to be more timely and accurately targeted at the higher-risk taxpayers.

Proposals

Interest limitation: verifying deductible interest amounts

- 14.12 On balance, the Government considers that it would be appropriate to ensure that Inland Revenue has more comprehensive data on interest expenses incurred and deducted by taxpayers with investments in residential land. To this end, consideration is being given to adding new fields to income tax return forms for total interest incurred in relation to land used for income-earning purposes and the amount of this interest that has been deducted.
- 14.13 Submissions are invited on this proposal.

New build issues

- 14.14 Chapters 7, 8 and 9 consider the proposed design of the exemption for new builds from interest limitation and the five-year bright-line test for new builds (“new build rules”). Since the design of these rules is a subject of this discussion document, whether any additional information will be required from taxpayers using the new build rules is still being worked through.
- 14.15 As mentioned in the earlier chapters on new builds, the Government proposes to use CCCs to verify that a property is a new build. To ensure Inland Revenue has sufficient information, existing forms could be altered so that additional information on new builds is requested, or taxpayers could be required to provide information by some other means.

Questions for submitters

The Government is seeking feedback on the following:

- Are there issues with adding new fields to income tax return forms for total interest incurred in relation to land used for income-earning purposes and the amount of this interest that has been deducted?
- What data points might Inland Revenue be able to use to verify that a person qualifies for the new build rules?
- What records should taxpayers have to provide or keep in order to show that they are eligible for the new build rules?
- Are there issues with relying on CCCs to determine whether a property is a new build? Are there integrity issues the Government needs to consider?
- If there are problems with relying on CCCs, what else could be used to verify that a property is a new build?
- What information could subsequent purchasers use to determine that a property they have acquired is eligible for the exemption for new builds from the proposed interest limitation rules?

Record keeping

- 14.16 Under section 22 of the Tax Administration Act 1994, taxpayers are required to keep and retain records for a period of at least seven years so their tax position can be readily ascertained by Inland Revenue in the event of an audit. This includes information or documents about sales, income and expenses, and assets and liabilities. Taxpayers use those records to fill in tax returns and finalise their tax position. Inland Revenue may review these records in case of an audit to ensure the correctness of assessments.
- 14.17 No specific record-keeping rules regarding the new interest limitation rules are proposed. Taxpayers would be required to retain records supporting their decisions on interest deductions under the new rules for seven years, in line with the current requirement for all records relating to determining tax liabilities.
- 14.18 However, should deductions denied become allowable if the disposal of the property is subject to income tax (see chapter 5), this may mean that in some cases residential rental property owners need to have records older than seven years if they want to claim the deductions that were denied in years prior to the disposal. This is consistent with the existing seven-year business record retention rule which starts in the income year immediately following the income year in which a deduction is claimed by a taxpayer.