

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

Questions and answers

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



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CONTENTS

Interest limitation proposals – questions and answers	7
Scope of the exemptions	7
Q1. Why are deductions allowed in situations where a tenant or boarder is within the main home, but not when they're in a separate dwelling on the same title?	7
Q2. Why is apportionment an option for the business premises exclusion under the interest limitation measure but not under the bright-line test?	7
Q3. Why is short-stay accommodation in a residential property not carved out along with hotels or motels? Don't they serve the same purpose?	7
Q4. Why is short-stay accommodation exempt if it is provided in the main home?	7
Q5. Why are retirement villages exempt from the interest limitation measures?	8
Q6. Will a retirement home exemption encourage developers to build retirement homes rather than regular residential properties?	8
Q7. Will residential investment property owned by Māori organisations besides papakāinga/kaumātua housing be exempt from interest limitation?	8
Q8. Has a carve-out been considered for social/community housing?	8
Q9. Has a carve-out been considered for homeless shelters, refuges, and similar forms of emergency shelter?	8
Q10. Has a carve-out been considered for situations where a person is renting to a family member (for example, parents renting to children as a means of helping them into their first home)?	8
Community Housing Providers and Kāinga Ora	8
Q11. How will the changes affect community housing providers?	8
Q12. How will the changes affect Kāinga Ora?	9
Māori land and housing	9
Q13. What is the impact for Māori land and housing?	9
Purpose-built rentals	9
Q14. How will interest limitation affect purpose-built rentals?	9
Disposal of property subject to limitation	9
Q15. Why is an exemption being considered for property taxed on sale?	9
Q16. Will the proposals to allow some interest to be deducted on sale reduce the effectiveness of the policy for helping first-home buyers get on the housing market?	10
Development exemption	10
Q17. Why is there an exemption for property development?	10
Q18. Do I have to be a developer to get the development exemption?	10
Q19. Will remediation work qualify for the development exemption?	10
Q20. What happens if I buy land without the intent to develop it but later do?	11
Q21. Does the exemption still apply if I hold the land on capital account?	11
Q22. Does the exemption still apply if I develop the properties for the purpose of holding them to rent out?	11
New build exemption – questions relevant to both the bright-line test and interest limitation	11
Q23. Why exempt new builds – is it fair to favour one class of investors over others?	11
Q24. What is a new build? Will significant improvements bringing up a property to the same standard as a new build qualify?	11
Q25. Does a 'new build' only include brand new houses?	11
Q26. How will the rules be enacted and when will they apply from?	12

New build exemption from interest limitation	12
Q27. I bought a property off the plans on the 10th of March 2021. It hasn't been completed yet – will I get the new build exemption?	12
Q28. If I buy a new build that received its code compliance certificate (CCC) before 27 March 2021, am I eligible for the new build exemption?.....	12
Q29. I have bought a large house that I want to convert into multiple units. Will I get the new build exemption?.....	12
Q30. If I bought residential land before 27 March 2021 but added a new build to the land after 27 March 2021, can I claim the new build exemption for the new build?	12
Q31. If I live in my property will I no longer get the new build exemption?.....	12
Q32. If the new build exemption applies to subsequent purchasers, how do I know if I qualify?.....	13
Q33. Why can't a property that qualified for the development exemption while being renovated be considered a new build when bought by an investor?.....	13
Q34. What interest deductions can I claim if I add a new build to my land? Is it just interest on the loan to construct the new build?	13
Q35. What happens if I don't qualify for the new build exemption?	13
Q36. Does buying bare land with the intention of building on it qualify for the new build exemption?	14
Q37. How long will the new build exemption apply for?	14
Q38. Will the new build exemption cover properties built recently, such as in the last two years?.....	14
New builds and the bright-line test	15
Q39. I bought residential land in 2019 and added a new build to the land in 2022, what bright-line test applies to me?	15
Q40. I bought a property in May 2021 that I am renting out. It is on a large section and I want to add a new build to the land. Would the new build bright-line test apply to my entire section?.....	15
Q41. I entered into a conditional agreement to purchase a newly-built property on 22 March 2021, conditions were satisfied on 30 March 2021, and settlement occurred on 20 April 2021. A code compliance certificate for the property was issued before 27 March 2021. What bright-line test applies?.....	15
Rollover – interest limitation	15
Q42. What does rollover relief in the context of interest limitation mean?.....	15
Q43. What rollover relief is being proposed for interest limitation?.....	15
Q44. Can I transfer land between different companies I own without being subject to interest limitation?	16
Q45. Are there any differences between the rollover relief proposed for the bright-line test and the proposed interest limitation rollover relief?.....	16
Rollover – bright-line	16
Q46. Does rollover relief provide an exemption from the bright-line test?.....	16
Q47. Will there still be an exemption for disposals of land on the death of a person (that is, inherited land)?.....	16
Q48. What are the new types of disposals that are being proposed to receive rollover relief?	16
Q49. How does the bright-line test work if I want to transfer a house into a family trust?	17
Q50. Why are there conditions on when land can be transferred to a trust?	17
Q51. What protections are there around the proposed trust relief to stop circumvention of the bright-line test?.....	17
Q52. What about if parents want to gift (or sell at cost) residential property to their children to help them get onto the property ladder?.....	17
Q53. Do the proposals allow me to transfer land to a look-through company without triggering the bright-line test?	17
Q54. Do the proposals allow me to transfer land to a partnership without triggering the bright-line test?.....	17
Q55. Can I transfer land between different companies I own?	18

Q56. How do these proposals affect Māori collectively owned land?	18
Q57. Will a company (that is a Māori authority) be able to access rollover relief?	18
Entities	18
Q58. Why is it proposed that some large companies will not have to apply the interest limitation rules? Won't this allow people to get around the rules by forming large companies?	18
Q59. How was a 50% threshold for residential investment property-rich companies settled on?	18
Q60. Why are properties exempt from the interest limitation rules (new builds and property under development) still counted as residential investment property under the 50% threshold?	18
Q61. Why is it proposed that Kāinga Ora will be excluded from the rules?	19
Interest allocation	19
Q62. Why is tracing the preferred approach?	19
Q63. Tracing is too complex for "mums and dads".	19
Q64. Looking at whether the loan is secured against a residential property instead might be simpler than tracing.	19
Q65. What can I do if I have an existing loan that I can't trace?.....	19
Q66. Won't tracing mean that rich people can get around the rules by borrowing to fund other business assets instead of borrowing to fund residential property?.....	20
Q67. Why is there no phasing-out of interest deductions for loans in foreign currency?.....	20
Q68. Won't it be very difficult to work out what proportion of my interest will be deductible if I had a loan before 27 March and have made repayments and drawdowns on it since then?	20
Q69. Why can't I apply the high water mark across my whole portfolio of loans?	20
Q70. Why is the high water mark so complex?.....	20
Interposed entities	20
Q71. Why are such complex rules required?.....	20
Q72. What should I do if I already have an existing interposed entity?.....	21
Q73. Why is the affected assets percentage for close companies and trusts 10% and 50% for all other types of interposed entities?	21
Helping family members with their first homes	21
Q74. I took out a mortgage to lend money to a family member for a deposit on their home. I pay tax on the interest income I am charging my family member and I currently claim deductions for the interest I pay to the bank. Am I affected by the interest limitation rules?	21
Q75. I increased the mortgage on my home in order to gift some money to a family member for a deposit on their home. Am I affected by the interest limitation rules?	21
Q76. I want to help my family member get on the housing ladder. I intend to borrow to buy a house to rent to my family member, and maybe sell it to them in the future once they've saved up more money.....	22
Q77. I am a guarantor on a loan that my family member used to buy their home. Am I affected by the interest limitation rules?.....	22

Interest limitation proposals – questions and answers

To help support understanding of the design proposals outlined in the Government's discussion document *Design of the interest limitation rule and additional bright-line rules*,¹ Inland Revenue has compiled a set of questions and answers. The closing date for feedback on the proposals was 12 July 2021.

Scope of the exemptions

Q1. Why are deductions allowed in situations where a tenant or boarder is within the main home, but not when they're in a separate dwelling on the same title?

The interest limitation rules are intended to capture property that can be easily substituted for owner-occupied property. Unlike rental accommodation within the main home, accommodation provided in an identifiably separate dwelling on the same title could be easily converted into an owner-occupied property. Including this kind of property in the interest limitation rules is intended to prevent conversion issues.

Q2. Why is apportionment an option for the business premises exclusion under the interest limitation measure but not under the bright-line test?

The bright-line test is designed to be just that – a bright line, or an easy to apply rule with clear results. For this reason, the business premises exclusion from the bright-line test works on an all-or-nothing basis. The Government thinks that this approach would not work for the interest limitation rule.

Q3. Why is short-stay accommodation in a residential property not carved out along with hotels or motels? Don't they serve the same purpose?

The aim is to put short-stay accommodation in a residential property on the same footing as long-term accommodation – that is, the Government wants to ensure that the income tax rules are the same between the two types of accommodation. A tax advantage for short-stay accommodation might encourage people to convert long-term rental properties to short-stay accommodation. This could have the effect of reducing housing supply for New Zealanders, which would be counter to the Government's objectives.

Q4. Why is short-stay accommodation exempt if it is provided in the main home?

The purpose is to make sure that short-stay accommodation is subject to the same tax treatment as long-term accommodation where it is provided in a property that could be used for owner-occupation.

In this case, short-stay accommodation provided in a house that is the owner's main home will be exempt from the interest limitation measure to align the treatment with that of flatmates and boarders. This is on the basis that this kind of accommodation cannot be sold separately from the main home and therefore is not substitutable for owner-occupied housing.

¹ Available at <https://taxpolicy.ird.govt.nz/publications/2021/2021-dd-interest-limitation-and-bright-line-rules>

Q5. Why are retirement villages exempt from the interest limitation measures?

The interest limitation rules are intended to cover property that could be easily substitutable for owner-occupation. Retirement villages do not seem to fall into that category as they are purpose built, and subject to a regulatory framework with legal requirements.

Q6. Will a retirement home exemption encourage developers to build retirement homes rather than regular residential properties?

We don't think so. New residential property development will be eligible for the new build exemption and should therefore not be affected by the interest limitation rules.

Q7. Will residential investment property owned by Māori organisations besides papakāinga/kaumātua housing be exempt from interest limitation?

The Government is not proposing that general residential investment properties (for example, inner city apartment blocks) owned by a Māori organisation be exempt from interest limitation, because in this situation the organisation is acting as a standard commercial landlord.

Q8. Has a carve-out been considered for social/community housing?

Social and community housing are provided by a number of entities, which are generally tax-exempt (usually charities or local authorities). As such, the Government does not currently consider that a separate carve-out is needed.

Q9. Has a carve-out been considered for homeless shelters, refuges, and similar forms of emergency shelter?

As these shelters are generally run by tax-exempt entities (usually charities), the Government does not currently consider that a separate carve-out is needed.

Q10. Has a carve-out been considered for situations where a person is renting to a family member (for example, parents renting to children as a means of helping them into their first home)?

The Government is concerned with reducing inequality and increasing access to the housing market for New Zealanders currently unable to afford their own home. It wouldn't be fair to provide a tax advantage depending on who a landlord rents a property to, as one of the Government's objectives is to ensure that every New Zealander has a home to call their own. To help achieve this, all potential tenants should be treated the same from a tax perspective.

Community Housing Providers and Kāinga Ora

Q11. How will the changes affect community housing providers?

Most community housing providers have charitable status, meaning that they pay no tax, and are therefore not affected by the changes. An additional tax exemption is also available for some community housing providers that are not charities. A small number of these providers are not charities or otherwise tax exempt and may be affected by the changes.

Q12. How will the changes affect Kāinga Ora?

Kāinga Ora and its wholly owned subsidiaries will not be subject to the proposed interest limitation rules. This will ensure that the rules do not impact Kāinga Ora's provision of public housing.

Māori land and housing

Q13. What is the impact for Māori land and housing?

The discussion document does not contain any specific proposals regarding the application of the tax rules to Māori land. Instead, feedback is sought to determine how the proposals would affect Māori housing (on Māori land and on general title land) and whether different tax treatment is necessary for Māori land.

The discussion document notes that a carveout may be appropriate for papakāinga and kaumātua housing, recognising the importance of this housing provision for Māori social and economic outcomes. Feedback is sought on this.

Purpose-built rentals

Q14. How will interest limitation affect purpose-built rentals?

There are no specific proposals in the discussion document regarding the purpose-built rental sector. However, the development exemption (if applicable) and new build exemption will both apply to purpose-built rentals. As such, developers of purpose-built rentals and owners of new purpose-built rentals will be able to continue deducting their interest expenditure in the same way as allowed under current law.

Some in the sector have expressed concern that, despite the new build and development exemptions, the interest limitation rules will negatively affect the provision of purpose-built rentals in New Zealand. The sector will have the opportunity to raise these concerns through the consultation.

Disposal of property subject to limitation

Q15. Why is an exemption being considered for property taxed on sale?

It's a question of fairness. One of the intentions behind the denial of interest deductions for residential investment property is to reduce a current tax advantage for property investors due to all interest being deductible while gains on sale are often not taxable. But where the property is taxed on disposal, not allowing deductions would represent over taxation of income. Consequently, it may be appropriate to allow a degree of interest deductibility.

None of the options outlined in chapter five of the discussion document, regarding disposal of property subject to interest limitation would enable full deductions on a current basis, other than the development and new build exemptions. This is to say, all proposed options represent a stricter tax treatment than under the status quo.

Full denial of deductions remains an option as that would have the strongest impact on the housing market.

Q16. Will the proposals to allow some interest to be deducted on sale reduce the effectiveness of the policy for helping first-home buyers get on the housing market?

The proposals recognise that there is a trade-off between housing market objectives and tax policy objectives. These proposals therefore reflect the consideration that if full actual income is taxed then there is less need to permanently disallow interest deductions.

The Government is not proposing that we adopt the proposals to allow interest to be deducted on sale; rather, it is seeking feedback through submissions on what people think of the idea considering both housing market and tax policy objectives.

Development exemption

Q17. Why is there an exemption for property development?

One of the Government's objectives in limiting interest deductibility is to improve the affordability of New Zealand's housing stock. Lowering demand is one aspect of this, however ensuring ongoing supply is equally important.

This means that, in designing the proposed interest limitation, consideration was given to ensuring that none of the proposed changes would discourage activity that increased housing supply. The inclusion of a development exemption is one of the main ways this will be achieved.

Q18. Do I have to be a developer to get the development exemption?

A property developer will get the development exemption for all properties held on "revenue account" (taxable on sale) under section CB 7 (held as part of a land-owning business).

A person could potentially make use of the development exemption if they engage in certain activities on the land (land subdivision or development or erecting buildings) for the purpose of creating one or more new builds (new dwellings). However, other requirements for obtaining an interest deduction, such the requirement that the interest expenditure has sufficient connection with deriving taxable income, will still need to be met to claim the deduction.

Q19. Will remediation work qualify for the development exemption?

Remediation work undertaken by those in the business of developing property will qualify for this exemption if they hold the property as taxable on sale under section CB 7 of the Income Tax Act 2007.

We invite submissions on whether remediation work undertaken by those not in the business of developing property should qualify for the development exemption.

Remediation work may be linked to prolonging the life of the building/making it habitable which adds to supply in the long term. Renovations that are not substantial, such as renovating a kitchen, may not qualify for this exemption. Comments are invited on where the line between cosmetic remediation and prolonging the life of the building is drawn.

Q20. What happens if I buy land without the intent to develop it but later do?

While there is no intention of developing the land then the development exemption does not apply.

However, a development exemption could apply if the use changes and the land is developed. Submissions are invited on when the interest should become deductible, for example, from when the development activity begins, and how this is determined.

Q21. Does the exemption still apply if I hold the land on capital account?

The development exemption will apply whether the property is held on capital or revenue account. Different tests may be used for determining whether the exemption applies, but the intent of both tests is that property development that adds to housing supply should qualify (provided the interest is otherwise deductible under ordinary principles).

Q22. Does the exemption still apply if I develop the properties for the purpose of holding them to rent out?

Yes. The exemption applies irrespective of whether the development is undertaken for the purpose of sale or for renting out by the person who develops the property.

New build exemption – questions relevant to both the bright-line test and interest limitation

Q23. Why exempt new builds – is it fair to favour one class of investors over others?

The Government wants to encourage the supply of new housing. The extended bright-line test and interest limitation rule, if applied to new build investment property, could disrupt the supply of new homes by reducing demand. The new build exemption is intended to encourage investment in new build properties instead of existing properties. This will be helpful in freeing up existing property for first home buyers to purchase.

Q24. What is a new build? Will significant improvements bringing up a property to the same standard as a new build qualify?

Generally, a new build would be defined as a self-contained dwelling that receives its code compliance certificate on or after 27 March 2021, or is acquired on or after 27 March but received its code compliance certificate in the last 12 months. The new build exemption and five-year new build bright-line are intended to apply to new builds that clearly increase housing stock, so the Government proposes that renovations which bring a property up to the standard of a new build would not qualify. It may be difficult to distinguish between renovations that add to housing stock and those that do not. However, the Government is consulting on this issue, and is interested in any tools that could be used to verify that a once uninhabitable dwelling has been renovated to the standard of a new build.

Q25. Does a 'new build' only include brand new houses?

No. It is proposed that a 'new build' would generally only include self-contained dwellings that are added to residential land and receive their code compliance certificates on or after 27 March 2021. A 'new build' could be constructed on site, or it could be constructed off

site and then added to the land (for example, a modular home), and could make use of existing materials. That means a ‘new build’ could include an existing dwelling that has been relocated, an existing dwelling that is converted into multiple dwellings, or a commercial building that is converted into residential dwellings.

Q26. How will the rules be enacted and when will they apply from?

Legislation will be introduced shortly before 1 October 2021, which is when the rules apply from. The legislation will be enacted by 31 March 2022.

New build exemption from interest limitation

Q27. I bought a property off the plans on the 10th of March 2021. It hasn't been completed yet – will I get the new build exemption?

If you acquire a property off the plans and it receives its code compliance certificate on or after 27 March 2021, it is proposed that you would qualify for the new build exemption.

Q28. If I buy a new build that received its code compliance certificate (CCC) before 27 March 2021, am I eligible for the new build exemption?

It depends on when you buy the new build. If you bought the new build before 27 March 2021, then it is proposed that you wouldn't be eligible for the new build exemption. On the other hand, if you buy the new build on or after 27 March 2021 and within 12 months of the new build receiving its CCC, then it is proposed that you would be eligible for the exemption. However, a subsequent purchaser (who acquires the new build more than 12 months after its code compliance certificate is issued) would not qualify for the new build exemption.

Q29. I have bought a large house that I want to convert into multiple units. Will I get the new build exemption?

Yes. If the house is converted into multiple self-contained dwellings (which means they have to have separate access, as well as their own kitchens and bathrooms) then we propose that you would qualify for the new build exemption. Even though you are making use of an existing structure, you are adding to housing supply by enabling more households to live in a building which may previously have only accommodated one household.

Q30. If I bought residential land before 27 March 2021 but added a new build to the land after 27 March 2021, can I claim the new build exemption for the new build?

Yes. You would be able to deduct interest (provided the interest would have been deductible in the absence of the limitation rules), as long as the new build receives its code compliance certificate on or after 27 March 2021. The new build exemption generally only applies where a dwelling is added to residential land and receives its code compliance certificate on or after 27 March 2021. The date of acquisition would not be relevant if a property receives its code compliance certificate on or after 27 March 2021.

Q31. If I live in my property will I no longer get the new build exemption?

You cannot get interest deductions where there is no income earning activity (for example, if you are living in a residential property without any flatmates, or you are using it as your

holiday home). We are consulting on whether private use of a new build would preclude the owner and any subsequent owners from claiming the new build exemption at a later date (for example, if the property is rented out again in the future). It is proposed that your use of the property would not affect whether you can access the five-year new build bright-line test, but the main home exclusion could apply if you are living in the property.

Q32. If the new build exemption applies to subsequent purchasers, how do I know if I qualify?

This depends on whether the private use of a new build prevents it being eligible for the new build exemption, which is something the Government is consulting on. If it does, then a purchaser would need to determine two things:

1. When the code compliance certificate was issued for the new build – was it issued on or after 27 March, and are you acquiring the property within the fixed period that the exemption applies to subsequent purchasers? (For example, if the exemption applies for 20 years, are you acquiring the new build within 20 years of the new build receiving its code compliance certificate?)
2. Whether the new build has ever been used privately, for example if it has been owner occupied or used as a bach.

Q33. Why can't a property that qualified for the development exemption while being renovated be considered a new build when bought by an investor?

The new build exemption is generally only available where a new dwelling has been added to land. While renovations may increase the life of a building, it could be administratively difficult to determine when a renovation is sufficiently significant to qualify for the new build exemption, which is why it is proposed that dwellings that have just been renovated without resulting in the creation of a new dwelling would not be eligible for the new build exemption.

Q34. What interest deductions can I claim if I add a new build to my land? Is it just interest on the loan to construct the new build?

It is proposed that any interest that would have been deductible before the interest limitation rules were introduced would continue to be deductible for new builds. This includes interest on the loan to construct the new build, interest on borrowings to acquire the land that the new build is on, and interest on loans to cover expenses such as maintenance, rates, and insurance that relate to the new build. However, such interest would only be deductible under the new build exemption after the code compliance certificate is issued, and where there is sufficient connection with deriving assessable income.

Q35. What happens if I don't qualify for the new build exemption?

If you don't qualify for the new build exemption, and you acquired your property on or after 27 March 2021, then you will not be able to deduct interest from 1 October 2021 and a ten-year bright-line test will apply to that property.

If you acquired your property before 27 March 2021 then interest for that property will be phased out over four years, from 1 October 2021, as set out in Table 1.

Table 1: Interest claimable from 1 October 2021 for properties acquired before 27 March 2021

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%

Q36. Does buying bare land with the intention of building on it qualify for the new build exemption?

Where you add a new build to land, it is proposed that the new build exemption would apply from the date the new build’s code compliance certificate is issued, provided the new build is being used to derive assessable income. However, the development exemption may apply while you are building the property.

Q37. How long will the new build exemption apply for?

The Government is consulting on how long the exemption should apply for and are considering three options.

1. The first option is for the exemption to apply in perpetuity for an initial or early owner of a new build, so the exemption would apply for the entire time they retain their interest in the land. An early owner is a person who adds a new build to their land or acquires a new build no later than 12 months after its code compliance certificate is issued.
2. The second option is for the exemption to apply in perpetuity for an initial or early owner, and for a fixed period for subsequent purchasers (for example, ten or twenty years from the date a new build’s code compliance certificate is issued).
3. The third option is for the exemption to apply for a fixed period for both initial or early owners and subsequent purchasers.

For properties with code compliance certificates issued before 27 March, it is proposed that the exemption would only apply to a person who acquires such a new build on or after 27 March provided the new build received its code compliance certificate within 12 months of the date of acquisition. It is proposed that subsequent purchasers (who acquire such a new build more than 12 months after it receives its code compliance certificate) would not have access to the exemption.

Q38. Will the new build exemption cover properties built recently, such as in the last two years?

It is proposed that the new build exemption would only apply to a new build that receives its code compliance certificate on or after 27 March 2021. A transitional rule would apply for new builds acquired on or after 27 March 2021 that received their code compliance

certificates before this date, provided the new build is acquired no later than 12 months after its code compliance certificate is issued. However, a subsequent purchaser (who acquires such a new build more than 12 months after it receives its code compliance certificate) would not qualify for the new build exemption.

New builds and the bright-line test

Q39. I bought residential land in 2019 and added a new build to the land in 2022, what bright-line test applies to me?

Which bright-line test applies depends on when the original plot of land was acquired, even if a new build is later added to the land or the land is subdivided. The previous five-year bright-line test would apply to land acquired in 2019, not the five-year new build bright-line test.

Q40. I bought a property in May 2021 that I am renting out. It is on a large section and I want to add a new build to the land. Would the new build bright-line test apply to my entire section?

We propose that only the portion of the land attributable to the new build would be subject to the five-year new build bright-line test. Existing tax principles for apportionment would apply to determine the amount of gains taxed on sale.

Q41. I entered into a conditional agreement to purchase a newly-built property on 22 March 2021, conditions were satisfied on 30 March 2021, and settlement occurred on 20 April 2021. A code compliance certificate for the property was issued before 27 March 2021. What bright-line test applies?

Which bright-line test applies depends on when you acquired the property. A property is 'acquired' when the sale and purchase agreement for the property is entered into. Since you acquired the property before 27 March 2021, the previous five-year bright-line test will apply.

Rollover – interest limitation

Q42. What does rollover relief in the context of interest limitation mean?

Rollover relief for interest limitation involves disregarding transfers or disposals of residential property in defined circumstances. For land acquired before 27 March 2021 by the person disposing of it, rollover relief would enable the new owner to continue to deduct a portion of their interest expense until 31 March 2025. If the proposed exemption for new builds from interest limitation is to apply in perpetuity to early owners and rollover relief is to apply to some transfers of these properties, rollover relief would enable the new owner to deduct all their interest expense relating to the property.

Q43. What rollover relief is being proposed for interest limitation?

As is the case with the rollover relief proposed in relation to the bright-line test, rollover relief for interest limitation is proposed for some disposals of land to yourself, to a family trust, to a look-through company or partnership, or to a Māori authority where it is a trust.

Rollover relief for interest limitation is also proposed where a residential property is transferred upon the death of its owner (that is, from the deceased's estate to a beneficiary of the estate) and where residential property is transferred under a relationship property agreement or as part of a company amalgamation.

Q44. Can I transfer land between different companies I own without being subject to interest limitation?

The proposed relief only applies to companies that have elected to become look-through companies.

Q45. Are there any differences between the rollover relief proposed for the bright-line test and the proposed interest limitation rollover relief?

Rollover relief would only apply for the purposes of the bright-line rules when there is zero consideration for a transfer of residential property. Under the proposed interest limitation rules, rollover relief will still be provided if there is consideration for the transfer.

Rollover – bright-line

Q46. Does rollover relief provide an exemption from the bright-line test?

No it is not an exemption. Rollover relief essentially means that a transfer is ignored so that no income tax is payable at that time and instead, taxation is deferred until a later disposal. When the property is eventually sold or disposed of, the original owner's date of acquisition will be used to determine whether the sale of the land was within the relevant bright-line period. If it was, the original owner's acquisition cost will then be used to determine the net gain.

Generally, the bright-line test provides that an amount derived on "disposing of residential land" is income of the person – the amount being at least the market value of the land. Rollover only deems the person disposing of the land to be disposing of it for cost – when combined with the corresponding deduction, the disposer should not be required to pay any tax in relation to the disposal.

The person acquiring the land is deemed to have acquired the land for the original owner's cost, and acquired it on the date the original owner initially acquired the land. If the acquirer then disposes of the land within the bright-line period (that is, within the relevant number of years since the date the disposer initially acquired the land) they will be taxed on any net gain from that disposal.

Q47. Will there still be an exemption for disposals of land on the death of a person (that is, inherited land)?

Yes. Inherited properties are provided an exemption from income tax under the bright-line test. This is not changing.

Q48. What are the new types of disposals that are being proposed to receive rollover relief?

Rollover relief is being proposed for some disposals of land to yourself, to a family trust, to a look-through company or partnership, or to a Māori authority (where it is a trust).

Q49. How does the bright-line test work if I want to transfer a house into a family trust?

At the moment, settling a residential property on a family trust can trigger the bright-line test. Even if you purchased your property before the bright-line test was introduced, transferring a property to a family trust could bring you into the bright-line test. We are proposing to provide rollover relief (that is, ignore the transfer) for certain disposals of residential property to a trust, where the following conditions are 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, and
- every beneficiary (excluding the beneficiaries who are also principal settlors) is associated with a principal settlor.

Q50. Why are there conditions on when land can be transferred to a trust?

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.

Q51. What protections are there around the proposed trust relief to stop circumvention of the bright-line test?

In addition to the general conditions required to be met to gain rollover, the general anti-avoidance provisions and the land-rich trust avoidance rule will apply to some trust arrangements intended to avoid the operation of the bright-line test. This could include where beneficiaries were appointed after the disposal of land to the trust for the purpose of circumventing the bright-line test and would deem the trustee(s) to have disposed of the land at market value.

Q52. What about if parents want to gift (or sell at cost) residential property to their children to help them get onto the property ladder?

Currently, the proposals do not include relief for such disposals as the proposals focus on transactions where there is no underlying change in ownership, aside from the legal structure used. Due to the complexity surrounding the large range of disposals and situations in which it may or may not be desirable to provide rollover relief, these sorts of arrangements are out of scope and not considered in the discussion document. However, the Government is interested in looking at such issues at a later date.

Q53. Do the proposals allow me to transfer land to a look-through company without triggering the bright-line test?

The Government proposes that rollover relief would also apply where property is transferred between a look-through company and its owners, so long as the property continues to be owned in the same proportions.

Q54. Do the proposals allow me to transfer land to a partnership without triggering the bright-line test?

The Government proposes that rollover relief would also apply where property is transferred between being partnership property and being personal property of the partners, so long as the property continues to be owned in the same proportions.

Q55. Can I transfer land between different companies I own?

The proposed relief only applies to companies that have elected to become look-through companies. Companies that have not made such an election would continue to be subject to the bright-line test on transfers of residential land between companies.

Q56. How do these proposals affect Māori collectively owned land?

Trusts that have elected to be Māori authorities would be entitled to rollover relief. The applicable conditions for these types for entities will likely be different than the conditions for family trusts given the different uses and purposes for trusts that own Māori collectively-owned land. The Government is interested in hearing from submitters about how rollover relief could work in this case and what some of the design features could look like.

Q57. Will a company (that is a Māori authority) be able to access rollover relief?

The proposals as they currently stand would not provide rollover relief to a company which has elected to be a Māori authority given the complexity surrounding transfers to and from companies. However, the Government is seeking feedback on to what extent the bright-line test affects Māori authorities which are companies and other issues that arise in the administration and governance of Treaty settlement land.

Entities

Q58. Why is it proposed that some large companies will not have to apply the interest limitation rules? Won't this allow people to get around the rules by forming large companies?

Large companies will still have to apply the rules if more than 50% of their assets by value are residential property. Some large companies are not in the business of renting out residential property but might own small amounts of residential property incidental to their core business. We want to make sure such businesses are not affected by the rules.

Q59. How was a 50% threshold for residential investment property-rich companies settled on?

The 50% threshold is consistent with the existing “residential-land rich” threshold in the residential loss ring-fencing rules, so taxpayers may already be familiar with it. We wanted to set the threshold at a level so that companies clearly under the threshold will not have to incur compliance and valuation costs in making sure they are below the threshold at all points during the year.

Q60. Why are properties exempt from the interest limitation rules (new builds and property under development) still counted as residential investment property under the 50% threshold?

Two reasons:

- The threshold is aimed at removing compliance costs and providing certainty for companies that hold residential investment property incidental to their core business. A company with mostly new builds still has a core business involving residential

investment property so should still have to trace to work out which interest deductions are limited.

- If the exemptions cease (for example, new build exemption expires or development stops), the company will have to work out how to allocate its interest. It may not be able to do this unless it had traced its borrowings to the properties initially.

Q61. Why is it proposed that Kāinga Ora will be excluded from the rules?

Even though Kāinga Ora provides social housing, Kāinga Ora is a Crown agency and not a charity or a “registered community housing provider”. Unlike other social housing providers, it therefore cannot benefit from existing tax exemptions for charities and registered community housing providers.

Kāinga Ora also undertakes some property development and building activity. Interest deductions relating to these activities should be covered by the development exemption anyway. So excluding Kāinga Ora will mean that it won’t have to restructure its borrowings to ensure that most/all of its interest deductions relate to development/building (and are therefore allowed), rather than providing social housing (and therefore limited, in the absence of an exclusion).

Interest allocation

Q62. Why is tracing the preferred approach?

Tracing is the preferred approach because it ensures that if you borrow to buy a residential investment property, your interest deductions will be limited; but if you borrow to invest in your business, your interest deductions will be allowed. It is also simpler than introducing a new approach because it is currently used by most taxpayers (other than companies) so many people will already be familiar with it.

Q63. Tracing is too complex for “mums and dads”.

Tracing is complex for large businesses with many different types of assets and sources of funds. It is not that complex for the average “mum and dad” investor with just one or two residential properties. People can also make tracing easier by having separate loans for separate purposes. The Government would like feedback on what aspects could be improved to make it simpler.

Q64. Looking at whether the loan is secured against a residential property instead might be simpler than tracing.

Many small business owners borrow against their home or a rental property to fund their businesses and the Government doesn’t want to limit interest deductions in these cases. Also, many banks’ mortgage agreements will say that the security given for a loan will secure any existing and future loans the borrower has with that bank. So loans can’t sensibly be linked to a particular property by seeing what it’s secured against.

Q65. What can I do if I have an existing loan that I can’t trace?

The discussion document proposes two transitional approaches for taxpayers in this situation: apportionment based on original cost or stacking/ordering based on market values.

The approaches are aimed at making compliance easier for taxpayers with pre-27 March loans. The Government welcomes suggestions of alternative approaches.

Q66. Won't tracing mean that rich people can get around the rules by borrowing to fund other business assets instead of borrowing to fund residential property?

There are pros and cons to each interest allocation approach. We chose tracing to make sure that if people borrow to invest in their business, their interest deductions will not be affected. It is also more intuitive and already used by most taxpayers.

Q67. Why is there no phasing-out of interest deductions for loans in foreign currency?

There would be a lot of complexity in making rules for foreign currency loans and few people have foreign currency loans. If a person wants to have the same treatment as a New Zealand dollar loan they can refinance their loan to be in New Zealand dollars.

Q68. Won't it be very difficult to work out what proportion of my interest will be deductible if I had a loan before 27 March and have made repayments and drawdowns on it since then?

The high water mark proposal means people who use a loan only to finance their rental property, or properties, acquired before 27 March will be able to deduct all of their interest (subject to phasing) provided the loan balance doesn't increase after 27 March.

Q69. Why can't I apply the high water mark across my whole portfolio of loans?

The proposal can be applied to each loan rather than adding them together. This reduces the complexity of the rules and still allows rental property owners to not have to trace their expenditure when they stay under the high water mark.

Q70. Why is the high water mark so complex?

Officials have designed the rule to reduce the complexity as much as possible. By having a loan finance only residential rental properties acquired before 27 March 2021 and keeping the loan balance under the high water mark, a person won't need to worry about the finer detail of the rules and also won't need to trace new borrowing for the next four years which should reduce their compliance costs. But as with all aspects of the design proposals, we are undertaking consultation to see if the proposals can be improved on or simplified.

Interposed entities

Q71. Why are such complex rules required?

The interposed entity rules are required to support the integrity of the interest limitation rules, by ensuring that people cannot get around limitation by borrowing to indirectly fund residential property. Most people will not have interposed entity structures so will not be affected by the rules.

The interposed entity rules would limit interest deductions on loans used to buy shares. How is this consistent with the Government's earlier promise that it would only limit interest deductions on loans used for residential property?

The rules would only limit interest deductions if the loan to buy the shares indirectly funds residential property. Limiting interest on such loans, to the extent they fund residential property, is consistent with the Government's promise to limit deductions on loans used for residential property.

Q72. What should I do if I already have an existing interposed entity?

It might be possible to restructure the entity's funding so that the interposed entities rules do not apply. A private ruling can be obtained from Inland Revenue to confirm how the taxation laws apply to any restructuring arrangement. You may wish to consult a tax professional about your particular situation.

Q73. Why is the affected assets percentage for close companies and trusts 10% and 50% for all other types of interposed entities?

The reason is because an apportionment approach is proposed for close companies and trusts, so that only a portion of interest deductions are denied, based on how much residential property the entity holds. In contrast, full denial is proposed for widely held interposed entities over the 50% threshold.

Further explanation: Close companies and trusts are controlled by a small group of people, so the owners will usually be closer to their day-to-day operations and more able to get the information needed to apply an apportionment approach. A 10% threshold is proposed for these entities so that if they own small amounts of residential property, the rules will not apply.

A simpler approach is proposed for widely held interposed entities, as owners of such entities typically do not have the same level of control as owners of closely held entities. A 50% threshold is appropriate so that interest is only denied when a widely held entity mostly holds residential property (but interest will be denied in full, not apportioned).

Helping family members with their first homes

Q74. I took out a mortgage to lend money to a family member for a deposit on their home. I pay tax on the interest income I am charging my family member and I currently claim deductions for the interest I pay to the bank. Am I affected by the interest limitation rules?

No. The interest limitation rules apply to loans used to derive income from residential investment property (for example, rental income or income from sale of the property). Your loan is not used to derive income from residential investment property.

Q75. I increased the mortgage on my home in order to gift some money to a family member for a deposit on their home. Am I affected by the interest limitation rules?

No. Under current law, interest expenditure involved in making a private gift is not deductible. The interest limitation rules would not affect this.

Q76. I want to help my family member get on the housing ladder. I intend to borrow to buy a house to rent to my family member, and maybe sell it to them in the future once they've saved up more money.

No special exemptions are proposed for property that is rented to family members, so the interest limitation rules would apply. If the house is a new build, you may be able to claim interest deductions against your rental income. There may also be other ways of helping your family member that do not fall within the interest limitation rules. There may also be bright-line consequences that apply when and if you do sell the house. We suggest consulting a tax advisor.

Q77. I am a guarantor on a loan that my family member used to buy their home. Am I affected by the interest limitation rules?

No. As a guarantor, you generally will not incur interest expenditure. Even if you did, your interest expenditure cannot be deducted under current law anyway as it does not relate to any taxable income.