Regulatory Impact Statement: Limiting interest deductibility on residential investment property

Coversheet

Purpose of Document	
Decision sought:	*Agree to limit interest deductions for resident investment property*
Advising agencies:	*Inland Revenue*
Proposing Ministers:	*Minister of Finance* *Minister of Revenue* *Minister of Housing*
Date finalised:	*8 September 2021*

Problem Definition
The key policy problem is housing affordability. The cost of buying a house is placing significant financial stress on households. House prices are high by international standards and rates of home ownership have been declining. There are also concerns about the affordability of rents and maintaining an adequate supply of new housing stock.

Executive Summary
Problem definition One of the Government's objectives for housing is to support more sustainable house prices, including by dampening investor demand for existing housing stock. This is in response to the decline of housing affordability for first-home buyers. To the extent that housing affordability concerns are due to excess demand and some of this demand is from investors, then reducing demand from investors may result in less upward pressure on house prices. **Possible options** While the tax system is not the primary driver of housing affordability, features of the tax system exacerbate the issue. In particular, investment in housing is tax-preferred as compared to investments that do not earn large gains. The policy question is therefore whether limiting interest deductions are an efficient and effective way of addressing these concerns and, if so, how interest limitation rules should best be designed.

Four options have been identified in addition to the status quo:

1. Option 1: Deny interest deductions for residential investment property.
2. Option 2: Deny interest deductions for residential investment property, but with an exemption for new builds.
3. Option 3: Deny interest deductions for residential investment property, but with an exemption for new builds and allow interest deductions where the property is taxable on sale (at the time of sale).
4. Option 4: Deny interest deductions for residential investment property, but allow interest deductions where the property is taxable on sale (at the time of sale).

This assessment focuses on possible changes to the tax system to address housing affordability. We acknowledge that non-tax measures have been recently implemented or are being considered but analysis of such options will not form part of this assessment.

Inland Revenue's preferred option

Inland Revenue has advised against any of these options to deny or limit interest deductions and prefers the status quo to all options. It considers that additional taxes on rental housing are unlikely to be an effective way of boosting overall housing affordability. While they will put downward pressure on house prices, they will put upward pressure on rents and may reduce the supply of new housing developments in the longer-term. The benefit of increased housing affordability for first-home buyers is outweighed by negative impacts on rents and housing supply, high compliance and administration costs for an estimated 250,000 taxpayers, and the erosion of the coherence of the tax system.

However, Cabinet has effectively decided not to proceed with the status quo, Option 1, or Option 4. Cabinet has agreed in-principle to proceed with the interest limitation policy with an exemption for new builds and has communicated this decision to the public. Of the remaining options, Inland Revenue recommends Option 3 over Option 2, which aligns with the preferred option in the Cabinet paper.

The potential impact of Option 3

Option 3 is likely to produce the least impact on increasing the affordability of housing for first-home buyers, but it will also have the lowest impact on decreasing the affordability for renters. As Option 3 has the smallest impact on rents, it will minimise the negative impact of the proposal on those less likely to own their home relative to the general population, such as low-income households, young people, Māori, and Pacific peoples.

Out of the four options, Option 3 will also have the smallest effect on the supply of new housing in New Zealand. While Options 2 and 3 may increase the price of housing to the detriment of owner-occupiers relative to Options 1 and 4, those building properties will be further incentivised to build new housing stock.

Option 3 is preferable to Option 2 given it would not tax investors beyond their economic income where the property is taxable on sale, thereby reducing over-taxation. This is a strong fairness argument and, on balance, outweighs the slightly reduced impact on housing affordability compared to Option 2.

Views from consultation with stakeholders and general public

Treasury

In general, the Treasury supports limiting interest deductions for residential property primarily because it addresses the Government's demand-side housing objective of moderating prices. In addition, in the absence of a comprehensive capital gains tax, the Treasury also supports it as a means of taxing more economic income from residential property investment. The Treasury is of the view that there should be no new build exemption, and that if there is one it should be as short as possible. While the Treasury does not support a new build exemption, it supports allowing interest deductions to offset any tax paid by investors on the sale of their properties. In summary, the Treasury prefers Option 4.

Te Tūāpapa Kura Kāinga – Ministry of Housing and Urban Development

In general, Te Tūāpapa Kura Kāinga – Ministry of Housing and Urban Development (HUD) opposes limiting interest deductions for residential property, because of the negative impacts this could have on new housing supply if a new build exemption is not long enough, and because of the negative impacts it is likely to have on rents, rental churn, the provision of emergency, transitional and public housing, and the feasibility of purpose-built rentals.

A long new build exemption (i.e. at least 20 years) is crucial to ensure that the new supply of houses is not reduced. HUD fundamentally disagrees with the Treasury's assumption that the length of the exemption would only impact the price of residential property, and that it would not have any material impact on supply. Housing supply is already somewhat responsive to changes in demand, particularly in certain urban areas (i.e. Auckland). Regulatory changes, such as the National Policy Statement on Urban Development (NPS-UD), will also increase the responsiveness of supply to demand. In the absence of a new build exemption, or one which is too short, there is a significant risk that current rates of supply will drop and the extra supply being enabled by these regulatory changes will not be delivered.

Views of the general public

While there were a broad range of submissions to the Government's discussion document, both for and against the proposal to limit interest deductions and its various design elements, most submitters opposed the general proposal.[1] The public considered that a range of exclusions to the proposal ought to be included, generally arguing that removing interest deductibility from various types of housing would not further the Government's objectives.

There was support for the new build exemption. Most submissions received on the new build exemption concerned its length and application. Some submitters favoured an exemption that applies to all owners of a new build for a period of time, ranging from a shorter exemption (for example, 10 years) to one that applies in perpetuity. Others preferred an exemption that only applies to initial owners of a new build, with a range of views on how long it should apply for.

The submissions that commented on the treatment of interest expenditure when residential investment property is sold considered that the interest should be fully deductible if the property is taxable on sale.

Submitters were largely concerned about increased administration and compliance costs; in particular, increased time and cost for tax agents. Other submitters were against additional information requirements as self-assessment and existing record-keeping rules would already require taxpayers to retain relevant information.

A range of other submissions were made on the discussion document – further detail on submissions can be found in the report "Interest limitation on residential investment property – key policy issues" (IR2021/325; T2021/1935 refers).

Limitations and Constraints on Analysis

The analysis is limited by a number of decisions made by Cabinet[2] prior to public consultation, including the following key in-principle decisions (full list of decisions can be found below at paragraph 14):

1. deductions for interest incurred on or after 1 October 2021 will be denied in full for interest on loans relating to residential property acquired on or after the 27 March 2021;
2. residential properties acquired before 27 March 2021 will be subject to phasing of interest denial at 25 percent per year over four years; and
3. exempt property from the denial proposal that is located in New Zealand, and purchased on or after 27 March 2021 and within 12 months of receiving its code compliance certificate.

Officials were not directed to consult on whether to proceed with the overall interest limitation policy. They were only directed to consult on the design of the policy (such as

1 Submissions closed on 12 July 2021 and 484 submissions were received. The majority of the submissions were from private landlords, although some were from tax advisors, property investors' representative groups, real estate agents, iwi groups, property developers, and engineers.

2 Cabinet Minute CAB-21-MIN-0045 (Amended) (8 March 2021).

the design of a new build exemption and whether interest deductions should be denied or merely deferred where the property is taxable on sale).

Analysis has not been done on the impacts of the overall interest limitation policy in conjunction with non-tax measures that have recently been implemented or which are being considered. This analysis has been prepared under time constraints. While a discussion document was produced concerning the general proposal, there has been very limited engagement on final design decisions and their overall coherence.

The impacts of each option are uncertain and depend on judgements about how much and how quickly housing supply responds to economic signals such as price.

Responsible Manager

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Inland Revenue

8 September 2021

Quality Assurance

Reviewing Agency:	Inland Revenue and The Treasury
Panel Assessment & Comment:	The Quality Assurance Panel with representatives from Inland Revenue and the Treasury has reviewed the Limiting interest deductibility on residential investment property regulatory impact statement (RIS) prepared by Inland Revenue and considers that the information and analysis summarised in the RIS partially meets the quality assurance criteria. Assessing the impact of each option depends on judgements about how much and how quickly housing supply responds to economic signals such as price. Further, the timeframe for policy development has been constrained. Given this, the panel considers that the information in the RIS is as complete as could reasonably be expected and identifies the main judgements, risks and uncertainties within the policy. However, the RIS does not analyse the impacts of the interest limitation policy in conjunction with other measures that have been recently implemented or are being considered. Further, while public consultation was carried out on the design of the proposal to limit interest deductibility, the public have not specifically been consulted on the problem definition and the broader range of

	options (although where stakeholders provided general comments on the proposal and suggested alternatives through the public consultation process, these comments have been incorporated into the RIS). Consequently, the panel cannot be confident that the full range of impacts have been identified or that the preferred options are the best options to address the problem and achieve the desired objectives.

Section 1: Diagnosing the policy problem

What is the context behind the policy problem and how is the status quo expected to develop?

1. Affordable housing is an important factor in determining people's wellbeing, particularly for low-income families where housing costs represent a higher proportion of total income. Renters generally live in poorer-quality housing that is more likely to be cold, damp, have mould, and need major repairs.[3] Home ownership in and of itself has long-term impacts on living standards and the distribution of wealth; New Zealand homeowners are typically 14 times wealthier than non-homeowners.[4] Furthermore, unaffordable housing disproportionately affects certain population groups such as low-income people, young people, Māori, and Pacific peoples.

2. **Housing affordability for owner-occupiers:** Housing costs compared to income are high in New Zealand compared to other OECD countries.[5] Nationally, house prices have been rising at a rate faster than wages over the past five years.[6] This trend has accelerated over the past year. House prices have increased 19.8 percent year-on-year to October 2020, with the median price at that time being $725,000.[7] Auckland's median house sale price for October was over $1 million for the first time. Homeownership rates are significantly lower now than they were at their peak in the 1990s and, as at the 2018 Census, were at their lowest since the 1950s.[8] However, home ownership rates have remained relatively stable over the last 5 years, which may reflect first-home buyers taking advantage of KiwiSaver deposits and low mortgage interest rates to enter the market. The decline in the proportion of households living in owner-occupied homes since the 1990s has not occurred uniformly across the population. For example, the decline has been faster for Māori and Pacific peoples. For Māori, the proportion of people living in an owner-occupied home declined across most of the 20th and early 21st century. From 1991, it has fallen from 57.4 percent to 47.2 percent by 2018. For Pacific people, it fell from 50.8

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[3] Stats NZ, Housing in Aotearoa: 2020, pp 77, 78, 80, 89. https://www.stats.govt.nz/assets/Uploads/Reports/Housing-inAotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf.

[4] Stats NZ, Housing in Aotearoa: 2020, pp 47. https://www.stats.govt.nz/assets/Uploads/Reports/Housing-inAotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf.

[5] OECD Better Life Index (2020). http://www.oecdbetterlifeindex.org/topics/housing/.

[6] Stats NZ, Housing in Aotearoa: 2020, pp 48, Figure 35. https://www.stats.govt.nz/assets/Uploads/Reports/Housing-in-Aotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf.

[7] REINZ Monthly Report October, pp 6. (Released 12 November 2020).

[8] Stats NZ, Housing in Aotearoa: 2020, https://www.stats.govt.nz/assets/Uploads/Reports/Housing-in-Aotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf.

percent in 1986 to 35.1 percent in 2018.[9] There are also considerable disparities in homeownership rates by age, with higher rates for older people.[10]

3. Housing investors have consistently accounted for over one-third of property purchase transactions over the past decade, with investors making almost 40 percent of purchases in September 2020. Investor bidding is likely to exacerbate price escalation and hinder the ability of owner-occupiers to purchase houses. At the same time, investors supply rental housing and a good supply of rental housing is an important part of a healthy housing market.

4. **Housing affordability for renters:** Housing costs tend to be a greater burden for renters than owner-occupiers.[11] In 2019, approximately one third of households were renters.[12] A greater proportion of lower-income households were renters, including nearly half of all households in the lowest income decile.[13] In 2020, 45 percent of renters spent 30 percent or more of their income on housing costs compared to 25 percent for owner-occupiers.[14] This high ratio of rents to incomes has been steady nationally for more than a decade.[15] However, rents have grown much faster than incomes for some groups, including renters in major centres (such as Auckland and Wellington).[16] Several factors explain increasing rent prices including the cost of supplying rentals and increased incomes.

5. **The drivers of unaffordability – supply issues:** Various restrictions impede the ability to increase housing supply in the short term. These include regulatory barriers (e.g. zoning and height restrictions), increasing costs of building, and a lack of long-term infrastructure planning. Contributing to the lack of planning is local councils' limited access to financial capital. As a result of these supply-side restrictions, increases in housing supply has not kept up with increases in demand over the last 40 years.

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9 Stats NZ, Housing in Aotearoa: 2020, Figure 16. https://www.stats.govt.nz/assets/Uploads/Reports/Housing-in-Aotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf.

10 Stats NZ, data from 1916-2018 Censuses. https://www.stats.govt.nz/news/homeownership-rate-lowest-in-almost-70-years.

11 Stats NZ, Housing in Aotearoa: 2020, Figure 33. https://www.stats.govt.nz/assets/Uploads/Reports/Housing-in-Aotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf.

12 Stats NZ, Housing in Aotearoa: 2020, p 36. https://www.stats.govt.nz/assets/Uploads/Reports/Housing-in-Aotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf.

13 Stats NZ, Housing in Aotearoa: 2020, p 46. https://www.stats.govt.nz/assets/Uploads/Reports/Housing-in-Aotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf.

14 Stats NZ, Housing in Aotearoa: 2020. https://www.stats.govt.nz/assets/Uploads/Reports/Housing-in-Aotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf.

15 Stats NZ, Housing in Aotearoa: 2020, p 46. https://www.stats.govt.nz/assets/Uploads/Reports/Housing-in-Aotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf.

16 Stats NZ, Housing in Aotearoa: 2020, Figure 34. https://www.stats.govt.nz/assets/Uploads/Reports/Housing-in-Aotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf.

6. **The drivers of unaffordability – demand issues:** Demand side factors are also putting upward pressure on prices. Falling interest rates have resulted in an increase in house prices, creating capital gains for existing property owners but worsening the position of prospective first-home buyers. The removal of loan-to-value ratio (LVR) restrictions by the Reserve Bank of New Zealand in response to COVID-19 allowed highly-leveraged investors to re-enter the market thereby exacerbating price pressures. However, these have since been reinstated. High population growth has also increased demand for housing over recent decades. While tax settings are not the primary driver of housing affordability, current tax settings incentivise investment in housing. In the context of constrained supply, lightly taxing housing relative to other forms of income will lead to higher property prices than would otherwise be expected.

What is the policy problem or opportunity?

7. The key policy problem is housing affordability. The cost of buying a house is placing significant financial stress on households and having perverse effects on equity, including intergenerational equity. House prices compared to income in New Zealand are high by international standards and have increased further over recent years. Rates of homeownership have declined significantly since the 1990s and a government objective is to increase the number of owner-occupiers. As noted above, this impacts people's living standards. The Government is also looking at a package of supply-side measures to address housing affordability in the long term. However, these measures will take some time to have an impact.

8. To the extent that affordability concerns are due to excess demand and some of this demand is from investors, then reducing demand from investors may result in less upward pressure on house prices. While the tax system is not the primary driver of housing affordability, features of the tax system exacerbate the issue. Investment in housing is tax-preferred compared to investments that do not earn large gains.[17] This creates an incentive to invest in housing over other asset classes and puts further upward pressure on property prices. The policy question is whether limiting interest deductions is an efficient and effective way of addressing these concerns and, if so, how interest limitation rules should best be designed.

What objectives are sought in relation to the policy problem?

9. As noted on 8 March 2021 (CAB-21-MIN-0045 Amended refers), Cabinet's policy objectives for the housing market are to:

   a. Ensure every New Zealander has a safe, warm, dry, and affordable home to call their own – whether they are renters or owners.

[17] Though some housing investments will not necessarily be tax preferred, such as where the bright-line test applies.

b. Support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers.

c. 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.

10. The intervention identified in this Regulatory Impact Statement seeks to primarily address the Government's demand-side housing objectives as set out in the second bullet point above: to support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers. However, the rules will also impact the other objectives for the housing market. One interaction between these three objectives is that more supply will support affordable housing for all New Zealanders, including first-home buyers, in the long-term.

Section 2: Deciding upon an option to address the policy problem

What criteria will be used to compare options to the status quo?

11. The likely impacts of the proposals will be assessed against a set of criteria to evaluate the impact of the proposals on the Government's demand-side objectives (above at paragraph 9). Those criteria are broadly whether the proposal:

a. improves housing affordability for first-home buyers;

b. maintains the rate of development of new housing stock; and

c. improves housing affordability in the rental market.

12. The options will also be evaluated against the traditional tax policy criteria of efficiency, equity, integrity, fiscal impact, compliance and administration costs, and coherence. These are described below.

a. **Efficiency and growth**: Taxes should be, to the extent possible, efficient and minimise (as much as possible) impediments to economic growth. That is, the tax system should avoid unnecessarily distorting the use of resources (e.g. causing biases toward one form of investment versus another) and imposing heavy costs on individuals and firms.

b. **Equity and fairness**: The tax system should promote fairness. The burden of taxes differs across individuals and businesses depending on which bases and rates are adopted. Assessment of both vertical equity (the relative position of those on different income levels or in different circumstances) and horizontal equity (the consistent treatment of those at similar income levels, or similar circumstances) is important.

c. **Revenue integrity**: The tax system should be sustainable over time and minimise opportunities for tax avoidance and arbitrage.

d. **Fiscal impact**: Tax reforms need to be affordable given fiscal constraints, and the tax system must raise sufficient revenue to support the Government's fiscal strategy.

e. **Compliance and administration cost**: The tax system should be as simple and low cost as possible for taxpayers to comply with and for the Inland Revenue Department to administer.

f. **Coherence**: Individual reform options should make sense in the context of the entire tax system. While a particular measure may seem sensible when viewed in isolation, implementing the proposal may not be desirable given the tax system as a whole.

What scope will options be considered within?

Decisions by Cabinet

13. Cabinet made the following in-principle decisions prior to public consultation.[18]

Interest denial generally

14. Interest deductions will be denied in full against the income from residential property investment for loans relating to residential property acquired on or after 27 March 2021.

15. Interest deductions will be denied for interest incurred on or after 1 October 2021.

16. Officials were directed to consult with stakeholders on the design details of the interest limitation proposal before seeking final decisions from Cabinet.

Property acquired before 27 March 2021

17. Residential properties acquired before 27 March 2021 will be subject to phasing of interest denial at 25 percent per year over four years.

18. Further borrowing against residential property drawn down after 27 March 2021 will be subject to full denial if it relates to residential properties acquired before 27 March 2021 (or treated as though they were acquired before 27 March 2021).

18 CAB-21-MIN-0045 Amended (8 March 2021). Most decisions are in-principle.

Property acquired on or after 27 March 2021

19. Residential properties acquired on or after 27 March 2021 as a result of an offer made before the end of the day of announcement will be subject to phasing of interest denial at 25 percent per year over four years.

New build exemption

20. Property located in New Zealand, and purchased on or after the 27 March 2021 and within 12 months of receiving its code compliance certificate (new builds) will be exempt from the proposal.

21. Officials were directed to consult on this exemption, including the following situations where the exemption would apply:

    a. Only to initial (or early) purchasers of a qualifying new build who purchase a property within 12 months of receiving its code compliance certificate.

    b. For a fixed period of ten years to both the first purchaser and subsequent purchasers of a qualifying new build.

    c. For a fixed period of 20 years to both the first purchaser and subsequent purchasers of a qualifying new build.

22. Officials were directed to consult on whether the above rule should be bolstered by also including a “first-occupied” test or another test, such as one based on when consent was granted to ensure that taxpayers do not have incentives to delay seeking code compliance certificates and eligibility for an exemption is objectively verifiable.

Deductions for property developers and other persons subject to tax on sale

23. Property developers will be allowed to continue deducting their interest expenses as incurred.

24. Officials were directed to consult on whether interest deductions should be denied or merely deferred if the taxpayer is not a property developer but is taxed on the disposal of their property under the bright-line test or another land sale rule.

Limitations on consultation

25. As is evident from the decisions above, Officials were not directed to consult on whether to proceed with the overall interest limitation policy. They were only directed to consult on the design of the policy (such as the design of a new build exemption and whether interest deductions should be denied or merely deferred where the property taxable on sale).

26. Analysis has not been done on the impacts of the overall interest limitation policy in conjunction with non-tax measures that have been recently implemented or are being considered.

27. This analysis has been prepared under time constraints. While a discussion document was produced concerning the general proposal, there has been very limited engagement on final design decisions and their overall coherence.

Experience from other countries

28. The United Kingdom have implemented a similar proposal, which restricts deductions from property income for finance costs for residential properties. The denial was gradually rolled out over 4 years in 25 percent increments and, as of April 2020, is fully phased in.

29. The main distinction between the UK and the proposal described in the Cabinet decisions above is that interest denial in the United Kingdom was accompanied by a 20 percent tax credit for denied deductions. For landlords on the standard income tax rate of 20 percent (i.e. those with income between £12,501 and £50,000), the interest is effectively fully deductible. For landlords on higher income tax rates (either 40 percent or 45 percent), their deductions are denied but they will obtain benefit of the tax credit, so effectively those landlords will get to deduct a portion of their interest expenditure.

30. One in five individual landlords are expected to pay more tax as a result of the measure (i.e. those on higher income tax rates). Given that only a small proportion of the housing market is affected by these changes, the UK government did not expect them to have a large effect on rent levels or house prices.

Alternative options ruled out

31. A capital gains tax was considered in the wider context of housing affordability during the Tax Working Group process and the 2020 New Zealand General Election but was ruled out.

What options are being considered?

32. Four options have been identified in addition to the status quo (allowing deductions for interest expenditure for all types of residential investment property):

    a. Option 1: Deny interest deductions for residential investment property.

    b. Option 2: Deny interest deductions for residential investment property, but with an exemption for new builds.

    c. Option 3: Deny interest deductions for residential investment property, but with an exemption for new builds and allow interest deductions where the property is taxable on sale (at the time of sale).

    d. Option 4: Deny interest deductions for residential investment property, but allow interest deductions where the property is taxable on sale (at the time of sale).

33. In-principle decisions have already been made by Cabinet to implement the policy to deny deductions and to include an exemption for new builds. These decisions have been publicly announced. However, this regulatory impact assessment will analyse all options.

34. This assessment focuses on possible changes to the tax system to address housing affordability. We acknowledge that non-tax measures have been recently implemented or are being considered but analysis of such options will not form part of this assessment.

Option 1 – deny interest deductions for residential investment property

35. Option 1 would deny deductions for interest expenditure incurred in deriving income from rental property. 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.

36. A range of residential investment property would be excluded from the proposal, including:

    a. land held by property developers;

    b. land outside New Zealand;

    c. employee accommodation;

    d. farmland;

    e. care facilities (for example, hospitals, convalescent homes, nursing homes, and hospices);

    f. commercial accommodation (for example, hotels and motels); and

    g. retirement villages and rest homes.

37. **Consultation**: Stakeholder support is low for this option. Most submitters to the Government's discussion document opposed the general proposal to limit interest deductions. Further, they consider that a range of exclusions to the proposal ought to be included (such as a new build exemption) generally arguing that removing interest deductibility from various types of housing would not further the Government's objectives. Variations to the proposal were put forward by submitters, including only denying 50 percent of deductions, and changes to the proposal's application date.

38. A range of submissions were made to exempt (to varying extents) specific types of housing, including private student accommodation, properties with multiple dwellings on a single title, purpose-built rentals, dual purpose buildings, and short-stay accommodation. Submissions on the proposal to exempt Māori communal housing (such as papakāinga housing) were mostly in favour.

39. Submitters generally favoured some form of exclusion for widely-held companies. This included support for an exclusion for a company that is, or is owned by, a Māori authority (given that such a company would generally not be widely-held as the shares are often held by a small number of trustees for the benefit of a wider group).

40. Submitters were mixed as to whether Kāinga Ora and its subsidiaries should be excluded from the rules. The majority of submitters wanted an exclusion for public or community housing. Some wanted an exclusion to apply on a property basis (as opposed to an entity basis), while others wanted an exemption for registered community housing providers or council-controlled organisations that provide community housing. Some submitters wanted exclusions for certain types of Māori entities (for example, Māori authorities or mandated iwi organisations).

41. Submitters were supportive of the exemption for property developers. There were mixed views as to the range of activities and persons who would qualify for the property development exemption.

42. Of submitters who commented on the administration of the proposal, their main concern was increased compliance costs. Some submitters agreed there may be some need for taxpayers to provide additional information to Inland Revenue. Other submitters were against additional information requirements because self-assessment and existing record-keeping rules already require taxpayers to retain relevant information.

43. **Improves housing affordability for first-home buyers**: Limiting interest deductibility could potentially help meet some of the Government's housing market objectives. Denying interest deductions for residential investment property would increase the tax cost of investment property compared to the status quo. All else being equal, this would put downward pressure on demand and therefore on property prices. Further, some investors may choose to sell their residential investment properties given the lower return on those properties. These effects would benefit first-home buyers.

44. Residential property is tax-favoured relative to more fully taxed investments such as interest income. This is because gains are generally not taxed and owner-occupiers are not taxed on their imputed rental income.

45. Owner-occupiers generally have a larger tax benefit relative to residential property investors. This is because ring-fencing rental losses has generally removed the tax advantages that investors could obtain above the tax advantages received by owner-occupiers.

46. This result arises as owner-occupiers face an effective income tax rate of 0 percent because they are not taxed on their gains or imputed rental income. Ring-fencing rental losses means that investors cannot use rental losses against other income. This means the effective income tax rate on their property portfolio cannot fall below 0 percent and may be greater than 0 percent.

47. Although owner-occupiers have significant tax benefits from investing in their own housing, interest disallowance will have no tax cost for them since they cannot deduct any housing interest now or under the proposed policy. First-home buyers would indirectly benefit from the policy due to house prices being lower than they otherwise would. Existing owner-occupiers may benefit due to the cost of purchasing replacement housing being lower (such as buying a larger house to live in), but may be disadvantaged by the price of their own current house falling or not rising as quickly as it otherwise would.

48. If limiting interest deductibility reduces the price that leveraged investors are willing to pay for new houses, this can reduce the incentive for developers to build and sell new houses. This can in turn reduce the supply of housing in the longer run which will tend to push up rents and offset any fall in the price of houses. The degree to which this would occur is uncertain.

49. **Maintains the rate of development of new housing stock**: Any negative impacts on prices reduces the incentive to build new houses. Therefore, we expect that the rate of development of new housing stock may be negatively impacted.

50. **Improves housing affordability for renters**: In the immediate term, property investors are constrained in their ability to increase rents in response to the interest denial policy. This is because rents can only be increased once every 12 months. After that period:

    a. In the short run, it is unlikely that landlords will be able to pass on any significant share of the additional tax costs, but this may not hold in specific circumstances where tenants have limited choice.

    b. In the medium and long run, rents may rise in line with any impact on the supply of new build housing. The reduction of interest deductions may lead to fewer investors purchasing property as rental accommodation and tend to reduce new house building and housing supply in the long run. This decrease of rental accommodation being added to the rental market may lead to increased rent.

51. To the extent that proposals place upward pressure on rents, this appears more likely to disproportionately impact low-income households, younger people, Māori, and Pacific peoples, who are less likely to own their home relative to the general population. In addition, as around 43 percent of children are living in rental accommodation, upward pressure on rents could have negative impacts on child wellbeing and child poverty. Increases in rents may also lead to an increase in spending on the accommodation supplement and temporary additional support, although it is difficult to quantify this impact at this stage.

52. **Efficiency and growth**: The deductibility of interest is a key consideration for debt-funded investors. The denial of such deductions will impact the profitability of their investments and cause investors to underinvest in housing relative to other investments where interest continues to be fully deductible (and if the property is also taxed under the bright-line, then the investment may be overtaxed). It could also lead to the inefficient and premature sale of property (though this may be mitigated by the bright-line test, depending on when the property was acquired).

53. Denying interest deductibility will encourage equity-funded investment over debt-funded investment in housing. This is because equity investors will be unaffected by the measure and can still access the tax preferences from housing.

54. **Equity and fairness**: Restricting mortgage interest deductions may be considered unfair (violates horizontal equity) as it disallows a deduction that is available for almost all other investments. However, it may be considered fair by some as it partially addresses the under-taxation of residential property investors relative to other fully taxed investments. There can be some cases where if an interest deduction is not allowed, an investor may be overtaxed. This would be the case where the disallowed interest deductions exceed the non-taxable gain.

55. The tax rate on investment in residential property would likely increase under Option 1 and be broadly progressive given that a greater proportion of income from renting residential investment properties tends to be earned by people on higher incomes.

56. If the proposal is applied to existing investment properties, then some investors may unexpectedly end up with negative cash flow. These investors may be forced to sell their property and potentially make losses.

57. **Revenue integrity**: The rules to implement this option may create opportunities for tax avoidance. Denying interest deductions will require taxpayers to distinguish between interest on debt obtained to generate rental income from interest on debt obtained to generate other business income. Both debts may be secured against residential property but distinguishing the interest deductions that are incurred for each income-generating purpose may be difficult.

58. **Fiscal impact**: The expected revenue gain from this option is $1.81 billion over the forecast period (2021/22 to 2024/25). This estimate is based on a number of assumptions, including the following:

a. Information from income tax returns for the 2019-20 income year are projected forward using Treasury's Budget 2021 forecasts.

b. Rising house prices will increase the nominal borrowing (and consequently the interest expenditure) of a portion of taxpayers.

c. Where the denial of interest expenditure results in an increase of the taxable income of the taxpayer, the additional income is taxed at the taxpayer's marginal rate.

d. Denial of interest deductions is phased in over time and is not fully denied until the 2025/26 income year.

e. Calculations are based on information from a subset of taxpayers and is scaled to provide population estimates.

59. **Compliance and administration cost**: Limiting interest deductions will come with high compliance costs for a large number of residential property owners. An estimated 250,000 taxpayers are likely to be affected by changes to interest deductibility. Of those, some may not have tax agents and only have one residential property. It may be particularly difficult for some taxpayers to determine whether their lending relates to residential property or to other business purposes. Further, taxpayers will be required to determine the deductions available for interest expenditure at each stage of the four-year phase out period.

60. Limiting interest deductions would involve increased administration costs for Inland Revenue over an extended period while different rules (based on the acquisition date and nature of properties) continue to be in place. These administration costs would arise from managing an increased number of customer contacts and supporting the integrity of the rules. This means a mixture of providing people with information to increase awareness and making sure that Inland Revenue uses its full range of interventions to support customers in meeting their obligations right from the start through to follow-up action, where there is clear evidence of deliberate non-compliance. This will involve:

a. ongoing proactive marketing and targeted education campaigns, followed by one-on-one interventions such as community compliance visits and integrity checks;

b. developing appropriate tools to assist customers to determine eligibility;

c. improving Inland Revenue’s data and analytical capability; and

d. taking audit action to address deliberate non-compliance.

61. **Coherence**: Limiting interest deductions will decrease the coherence of the tax system. A principle underlying the tax system is that generally only the amount of income after deducting any associated costs is taxable. This policy would create an exception to that general rule.

Option 2 – deny interest deductions for residential investment property, but with an exemption for new builds

62. Option 2 is similar to Option 1, except that there is an exclusion for interest expenditure incurred in deriving income from property that qualifies as a new build. The discussion document consulted on two design features of the proposed new build exemption:

    a. who is eligible for the exemption (for example, whether to only allow interest deductions for the initial purchasers of those new builds or allow interest deductions on new builds to be claimed for a fixed period (with both initial and subsequent purchasers being allowed to claim interest deductions during that period)); and

    b. the length of the exemption (for example, 10 years, 20 years, or in perpetuity from when the code compliance certificate was issued).

63. **Consultation**: Submitters to the Government's discussion document generally considered that if the proposal went ahead, that a generous new build exemption ought to be provided. However, general critique focussed on how the exemption could increase the price of new builds (therefore negatively impacting owner-occupiers) and undermine the interest limitation policy.

64. Submitters were largely in favour of the exemption applying to both initial owners and subsequent purchasers as this will likely increase the resale value of the property (providing a greater incentive for the initial investor to purchase a new build). However, many submitters did not think the exemption should be passed on to a subsequent purchaser, either because it was unfair to advantage someone who had not invested in a "new" new build, or because it would drive up the price of new builds and price owner-occupiers out of the new build market.

65. The most popular option was for a fixed period to apply to both the initial owners and subsequent purchasers of a new build. The option of an in-perpetuity exemption for initial owners, plus a fixed period for subsequent purchasers, was also popular.

66. **Improves housing affordability for first-home buyers**: This option would improve housing affordability for first-home buyers (given the increased tax cost of investment in existing builds), but to a lesser extent to than Option 1.

67. The new build exemption will increase the return for a debt-funded investor in a newly built residential property, relative to the return from that investor purchasing an existing residential property. This means that a new debt-funded investor will be willing to pay less for an existing property compared to a comparable new build.

68. The shift in demand towards new builds could, unchecked, lead to an increase in the price of new builds relative to existing homes. However, the shift in investor demand to new builds will reduce the impact that removing the deductibility of interest has on moderating house price growth. This is because the new build exemption will lead investors to value new builds closer to how they were valued prior to the tax change.

A longer new build exemption would further reduce the impact that the policy has on moderating house price growth.

69. The new build exemption will not just affect demand for new builds. In response to debt-funded investors moving into the new build market, owner-occupiers and equity-funded investors will purchase fewer new builds and more existing homes. That means that the length of the new build exemption modifies the impact that interest limitation has on the demand for, and growth in prices of, both new and existing homes.

70. If new and existing homes on the market are very closely substitutable, then we would expect that buyer substitution is likely to mean that Option 2 would be much less effective than Option 1 in putting downward pressure on the price of existing houses and might in the end have little effect in reducing these prices. However, Te Tūāpapa Kura Kāinga – Ministry of Housing and Urban Development and Inland Revenue do not consider that this is likely to be the case. The characteristics (in particular, the location, typology, and quality) of new builds as compared with existing housing are sufficiently different that the relative pricing between new builds and existing housing will diverge more than they do currently. This could allow a price reduction for purchasers of existing housing while maintaining a supply benefit from the continued provision of new builds.

71. The impact of Option 2 on housing affordability for first-home buyers is also heavily dependent on the length of the new build exemption. Inland Revenue considers that a longer exemption is likely to result in less downward pressure on house prices. However, Inland Revenue considers that in the long run housing affordability is unlikely to be promoted by measures which reduce the supply of housing. Given that Inland Revenue considers that a shorter exemption will reduce the supply of housing (see analysis below), Inland Revenue supports a longer new build exemption.

72. **Maintains the rate of development of new housing stock**: The impacts of the new build exemption on the Government's objectives, including the rate of development of new housing stock, are uncertain.

73. The extent of land use regulation impacts how much demand changes (including those caused by tax changes) affect the supply of land for a particular use (such as for residential property) and the price of land. The more restrictive land use regulations are (restricting the ability to use land for residential purposes), the more a tax change that increases demand for residential property development will impact the price and the less it will impact on supply.

74. Inland Revenue has recommended a longer new build exemption to minimise impacts on supply. Putting aside the question of the competitive nature or otherwise at the periphery of the city, clearly within a city land can be put to alternative uses, in terms of residential or commercial land, typology of housing (e.g. terraced or standalone), and size of houses. The number of landowners make it difficult to argue that within city limits there is insufficient competition between land owners for tax to influence choices. Therefore, tax changes (including the extent of a new build exemption) will likely influence decisions, and thereby influence total housing supply.

75. **Improves housing affordability for renters**: Inland Revenue's view is that interest limitation will increase rents and that in the long run, affordability for renters will not be promoted by taxing the provision of rental properties by landlords more heavily. However, the effect of this option on rents will be less significant compared to Option 1.

76. **Efficiency and growth**: As for Option 1, the deductibility of interest is a key consideration for debt-funded investors. Allowing interest deductions for new builds will likely cause debt-funded investors to focus investment on new builds when they may not have otherwise done so. This may lead to less efficient decision making. This will have an impact on relative prices (described above). Again, equity-funded investors will not be directly affected by the proposals.

77. **Equity and fairness**: As described above, the proposal to limit interest deductions may erode horizontal equity in relation to other types of investment, which generally are entitled to deductions for all expenditure incurred in deriving income from that investment. However, to a lesser extent than Option 1.

78. This option may be seen as unfair for debt-funded investors who acquired residential property prior to 27 March 2021. While these investors are able to claim interest deductions under the four-year phase out period, the deductibility of interest is a major consideration for investors and will impact the profitability of past investments.

79. **Revenue integrity**: As described for Option 1, Option 2 is expected to negatively impact the integrity of the tax system. The method for determining what deductions should be denied to what categories of persons is a complex task given the range of structuring that could occur.

80. **Fiscal impact**: Denying interest deductions under Option 2 will also raise revenue, but to a lesser extent than Option 1. The expected revenue gain from this option is $1.22 billion over the forecast period (2021/22 to 2024/25). In addition to the assumptions provided above under Option 1, this option includes the following assumptions:

    a. The new build exemption would be for 20 years and be available for all purchasers of the relevant property.

    b. The forecast value of new residential builds is derived from Treasury's Budget 2021 forecasts.

    c. The behavioural change induced by the new build exemption increases the proportion of new builds being bought for use as rental property from 35 percent to 75 percent.[19]

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[19] Census data indicates that 35% of households are not living in owner-occupied housing. We have assumed that a similar proportion of new builds are currently being bought by investors. Behavioural assumptions incorporated in the new build exemption costing see this increase to 75%.

d. Interest expenditure is calculated using the repayment profile generated from a 25-year loan.[20]

e. The tax impact of the new build exemption is calculated using a marginal tax rate of 24.55 percent.[21]

81. **Compliance and administration cost**: In addition to the extensive compliance and administration costs described for Option 1, this option would also require current and prospective residential property investors to consider the following:

a. Whether a property they are seeking to purchase is a new build or an existing build. This may require taxpayers to obtain a code compliance certificate from the relevant territorial authority.

b. Whether their current lending relates to a new build or an existing build. This would include a more complex tracing exercise than Option 1 where lending relates to both new builds and existing builds. This may also lead to various financing and debt reorganisations that may have not otherwise been necessary.

i. For existing properties, taxpayers will have to apply the interest phase-out rules to each payment (in respect of residential land purchased before 27 March 2021).

ii. For 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).

82. Owners of new builds and property developers will need to maintain records and sufficient evidence to establish that they qualify for the new build or development exemption, and in particular to support their approach to tracing through their lending.

83. **Coherence**: Option 2, as an overall proposal, is less coherent than Option 1. This option creates artificial boundaries based on when the property was built, which will make the taxation of residential investment property more difficult to navigate and administer. Option 2 will also undermine the coherence of the broader tax system given it will create a carve out to the general principle that expenditure incurred in business is deductible.

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20 In the absence of information on the average loan term for new residential property mortgages, a 25-year term was selected.

21 24.55% is the average marginal tax rate of those Inland Revenue could identify as owners of residential rental properties with interest expenditure.

Option 3 - deny interest deductions for residential investment property, but with an exemption for new builds and allow interest deductions where the property is taxable on sale (at the time of sale)

84. Option 3 is similar to Option 2 in that interest deductions will be generally denied for residential investment property (excluding new builds), however, this option would allow interest deductions for a property that is sold and subject to tax (including property sold within the relevant bright-line period). The rationale for allowing interest deductions on a taxable sale is to target the policy to where taxes are low relative to actual income (because the gain is untaxed).

85. **Consultation**: The discussion document consulted on the following options where a property that is sold is subject to tax:

    a. Permanently denying all interest deductions subject to the interest limitation rule.

    b. Allowing interest deductions when a property is subject to tax on sale (for example, because the sale is subject to the bright-line rule).

    c. Allowing all interest deductions on sale, except to the extent there is an untaxed increase in value of the property.

86. Submissions that commented on this design issue generally considered that interest should be fully deductible when the sale of a property is subject to tax. Many also considered that at least some interest should be deductible when capital account (non-taxable) property is sold. A small number of submitters thought that there should be no deduction for deferred interest on sale in order to maximise the impact of the policy on the housing market.

87. **Design of Option 3**: This assessment analyses the design of Option 3 where the proposal allows interest deductions when a property is subject to tax on sale – for example, because it is caught by the bright-line rule (see paragraph 85.b).

88. **Improves housing affordability for first-home buyers**: This option would still improve housing affordability for first-home buyers but to a slightly lesser extent than both Options 1 and 2. Officials advised that the impact of this design issue (whether to fully deny or just defer deductions) will be significantly smaller than the impact of the length of the new build exemption. However, even if interest deductions are deferred rather than permanently denied, investors will be worse off compared to the status quo.

89. **Maintains the rate of development of new housing stock**: The impact of this option on the rate of new housing supply is likely to be similar to that of Option 2. Option 3 will further reduce the effect of the overall policy on house prices and should produce less of a disincentive to build new supply (compared to Options 1 and 2). However, the impact of Option 3 on new housing supply is likely be small relative to the potential impact of Option 2.

90. **Improves housing affordability for renters**: Affordability for renters in the long run will not be promoted by taxing the provision of accommodation by landlords more heavily under the general proposal. However, Option 3 would have the smallest negative impact on long-term housing supply, and therefore will have the least tendency to increase rents.

91. **Efficiency and growth**: Again, for debt-funded investors interest deductibility is a key consideration. The deferral of interest deductions for investors in property who are taxable on sale will likely mitigate some efficiency concerns because interest deductions to those properties will be available at some point. However, there would still be a preference to invest in new builds, given that interest would be deductible in the year it was incurred.

92. **Equity and fairness**: This option may erode horizontal equity in relation to other types of investment, which generally are entitled to deductions for all expenditure incurred in deriving income from that investment in the year it was incurred. However, horizontal equity would be eroded to a lesser extent under Option 3 than under Options 1 and 2.

93. Where a sale of a property is taxable, all of the income from owning the property has been taxed, so all deductions should be allowed. The deferral of the deduction (until the time of sale) is appropriate because it may not be clear whether the sale is taxable until the year of sale (especially where the bright-line rule applies). This then aligns those deductions with the taxation of the gain, which removes a timing advantage (as the gain accrues over the entire holding period).

94. **Revenue integrity**: This option is expected to negatively impact the integrity of the tax system, given the complexity involved and the opportunities for avoidance and arbitrage. The methods for determining what deductions should be denied to what categories of persons is a complex task given the large range of structuring that could occur.

95. **Fiscal impact**: Denying interest deductions under Option 3 will also raise revenue, but to a lesser extent than Options 1 and 2. The expected revenue gain from this option is $1.12 billion over the forecast period (2021/22 to 2024/25). In addition to the assumptions for Options 1 and 2 above, this option includes the following assumptions:

    a. Interest deductions will be allowed when a property is subject to tax on sale (for example, because it is caught by the bright-line rule).

    b. Disallowed interest deductions accumulate through time.

    c. Eight percent of properties are sold each year (CoreLogic data), of which 40 percent are subject to tax on sale. It has been assumed that for those properties, 80 percent of the interest expenditure will be deductible (as that amount is below the capital gain).

d. The total interest deductions allowed for properties taxable on sale has been reduced to take into account the impact of the new build exemption and avoid over-estimating the fiscal impact.

e. The tax effect of allowing interest deductions for properties within the taxable-on-sale exemption under Option 3 is calculated using a 24.55 percent tax rate.[22]

96. **Compliance and administration cost**: In addition to the compliance and administration costs described for Options 1 and 2, Option 3 will also require taxpayers to retain comprehensive records of interest expenditure incurred over the period of ownership of the property for a longer period than otherwise required to by law. Investors who know that the sale will be taxable will keep all records to ensure they can claim their interest deductions. For investors who are not expecting to be taxable on sale, best practice may be to maintain comprehensive records throughout the period of ownership (should the sale be taxable and they can then claim interest deductions).

97. **Coherence**: Option 3 will decrease the coherence of the tax system as a whole, but to a lesser extent than Options 1 and 2. As described above, the interest limitation policy will undermine the coherence of the tax system given it will create a carve out to the general principle that expenditure incurred in business is deductible. However, Option 3 erodes the coherence of the tax system to a lesser extent as it allows the deduction of some of those business expenses consistently with that general principle. Further, Option 3 reflects another general principle of the tax system to only tax a person to the extent of their income.

Option 4 – deny interest deductions for residential investment property, but allow interest deductions where the property is taxable on sale (at the time of sale)

98. Option 4 is a combination of Options 1 and 3. Option 4 would deny interest deductions for residential investment property but allow interest deductions where the property is taxable on sale (at the time of sale).

99. The analysis for Option 4 largely follows the analysis for Option 1 but modified to take into account the impact of allowing deductions on a taxable sale. Option 4 would improve housing affordability for first-home buyers better than Options 2 and 3, but to a slightly lesser extent than Option 1. With no new build exemption under Option 4, the rate of development of new housing stock may be negatively impacted, which may cause rents to increase in the medium and long run (similar impact as Option 1).

100. Option 4 would likely have similar but slightly better outcomes to Option 1 in relation to efficiency and growth, equity and fairness, and coherence. Option 4 would be fairer to those that are taxable on sale, because if an interest deduction is not allowed, an investor may be overtaxed where the disallowed interest deduction exceeds the non-

[22] 24.55% is the average marginal tax rate of those Inland Revenue could identify as owners of residential rental properties with interest expenditure.

taxable gain. However, the fiscal impact of Option 4 would likely be slightly worse than for Option 1.

Key stakeholder view: Treasury

101. In general, the Treasury supports limiting interest deductions for residential property primarily because it addresses the Government's demand-side housing objective of moderating prices. In addition, in the absence of a comprehensive capital gains tax, the Treasury also supports limiting interest deductibility for residential property as a means of taxing more economic income from residential property investment.

102. The Treasury recognises the need to balance the Government's objective of moderating house prices and supporting a high level of housing supply and affordable rents. The Treasury's assessment of the evidence is that this policy is likely to have only limited impact on either housing supply or rents, and will have more impact on land prices. This is because urban land markets are relatively uncompetitive and therefore construction activity does not fully respond to the typical economic signals of house prices alone.

103. **New build exemption**: Consequently, the Treasury is of the view that there should be no new build exemption, and that if there is one it should be as short as possible (consistent with Options 1 and 4).

104. This is because the Treasury's judgement is that a longer exemption for new builds will reduce the impact of the measure on overall demand for housing and therefore house price inflation, while it will not have any material impact on housing supply given the uncompetitiveness of urban land markets. This lower impact on price inflation will be true of all homes, not just the new homes to which the exemption applies. While, for a very short time, there may be a spike in the demand for new builds as highly leveraged investors look to purchase more to take advantage of the exemption, in most locations demand and prices for new builds and existing houses will swiftly equalise as other buyers (such as prospective owners) would be displaced and instead purchase existing properties.

105. The Treasury acknowledges that there may be a small, short-run reduction in construction activity from a shorter exemption, but this would occur primarily in locations where land supply is plentiful.

106. Furthermore, the Treasury considers that a new build exemption could distort the type of property that people live in. If so, this will be welfare-reducing. For example, some owner-occupiers who would have preferred a new build will be pushed into the existing home market by investors purchasing new builds in order to access the exemption. Some renters who, for affordability reasons, might have preferred to live in an older house, will instead move into the new build market. A longer new build exemption will lead to a greater distortion in the market, and a greater welfare loss.

107. **Allowing interest deductions to offset tax when property sold**: While the Treasury does not support a new build exemption, it supports allowing interest deductions to offset any tax paid by investors on the sale of their properties (as

outlined in Options 3 and 4). Allowing a deduction for interest payments when the property is taxable on sale will avoid the double taxation of the economic income from residential investment property. The Treasury agrees that these deductions should be limited so that they can only be used to offset tax on the gains on the sale of property, which would reduce the integrity risks that could arise if taxpayers could offset deductions against their other income.

108. In summary, the Treasury supports Option 4.

Key stakeholder view: Te Tūāpapa Kura Kāinga – Ministry of Housing and Urban Development

109. Te Tūāpapa Kura Kāinga – Ministry of Housing and Urban Development (HUD) does not support limiting interest deductions for residential property investors. While limiting interest deductions may help support the Government's objective of supporting more sustainable house prices, including by dampening investor demand for existing stock, reducing investor demand for property could have a significantly negative impact on supply, and is likely to also have a number of unintended negative impacts including:

a. **Increased rents and rental churn** – While the ability for landlords to pass their increased tax costs onto their tenants is constrained in the immediate term, in the short term we would expect there to be some upward pressure on rents, particularly where renters' choices are constrained. Increased tax costs may also lead to landlords selling investment properties, displacing tenants who will need to incur costs associated with finding new rental accommodation.

   To minimise the negative impacts of the interest limitation rules on renters, HUD considers that interest deductions for properties already owned prior to 27 March 2021 should not be limited. If interest is to be limited, then the phase-out period for already owned investment properties should be longer and last for at least 10 years.

b. **Reduced feasibility of purpose-built rentals in New Zealand** – Purpose-built rental (PBR, also known as build to rent) is a developing sector in New Zealand and stakeholders have raised concerns that limiting interest deductions will significantly reduce the feasibility of PBR. While the development and new build exemptions will apply to new PBR developments, the eventual expiration of the new build exemption will affect the valuation of the developments and make it less likely that they will be built.

   PBR could be an important way to help New Zealand's housing needs. If supported through the right settings, large scale PBR has the potential to deliver 6,500-7,000 units over the next 10 years. Owing to differences in typology of large-scale PBR and traditional build-to-sell developments, this would likely lead to extra new supply overall than if regulatory settings do not support PBR. PBR also provides a number of other benefits including high quality properties, economies of scale in terms of maintenance and upkeep, longer and more flexible lease periods, shared spaces facilitating community and social good, and housing in suitable locations close to public transport and employment.

To reduce the impact of the interest limitation rules on PBR, HUD considers it necessary to exclude PBR from the scope of the interest limitation rules.

c. **Reduced supply of emergency, transitional and public housing** – While registered community housing providers (CHPs) will often be charities or covered by a separate income tax exemption, and Kāinga Ora (which is not tax exempt) will be excluded from the interest limitation rules, the interest limitation rules may still lead to a reduction in the supply of public housing.

Both CHPs and the Government lease properties from private landlords for use as emergency, transitional and public housing. These private landlords will be affected by the interest limitation rules and will have a higher tax cost in relation to leasing their properties for use as public housing. This higher tax cost could lead to a reduction in the number of properties made available for use as public housing, or an increased cost to CHPs and the Government in procuring these properties.

Some council housing may also be provided through council-controlled organisations (CCOs) which are not exempt from income tax, and so will face an increased tax cost from the interest limitation rules.

Māori entities that are not registered charities or CHPs may also provide some social housing. These entities providing social housing will also face increased tax costs from the rules.

To minimise the impact of the interest limitation rules on the provision of emergency, transitional and public housing, HUD considers it would be necessary to exclude all properties used for these purposes from the scope of the rules, regardless of the underlying ownership of the properties.

110. The design of the interest limitation rules may be able to minimise these negative unintended consequences, however, this may reduce the impact of the rules on house prices. Furthermore, designing the rules to minimise unintended consequences is likely to increase the complexity of the rules, making them harder for Inland Revenue to enforce and for tax agents and taxpayers to comply with.

111. **New build exemption –** HUD considers that a long new build exemption (i.e. at least 20 years) is necessary to minimise the impact of the interest limitation rules on the supply of new housing. Long-run housing affordability is not supported by measures that reduce the supply of new housing and there is a significant risk that supply will reduce if the exemption period is too short.

112. Housing supply is already somewhat responsive to changes in the price of housing and the National Policy Statement on Urban Development (NPS-UD) and related work will increase this responsiveness. Denying interest deductions would therefore significantly reduce the supply of housing in the medium to long term and create a risk that the extra housing being enabled by the NPS-UD and related work would not be supplied. A long new build exemption would alleviate much of this impact. HUD therefore recommends that the new build exemption should last for at least 20 years from the date of CCC, so as to minimise the impact that denying interest deductions has on the supply of new housing.

How do the options compare to the status quo/counterfactual?

	Status quo – allow interest deductions for residential investment property	Option 1 – deny interest deductions for residential investment property	Option 2 – deny interest deductions, except for new builds	Option 3 – deny interest deductions, except for new builds and properties taxable on sale	Option 4 – deny interest deductions, except for properties taxable on sale
Improves affordability for first-home buyers	0	+	+ / 0	+ / 0	+
Maintains the rate of development of new housing stock	0	- -	-	-	- -
Improves affordability for renters	0	- -	- / - -	- / - -	- -
Efficiency and growth	0	-	-	-	-
Equity and fairness (horizontal and vertical)	0	- -	-	-	-
Revenue integrity	0	-	-	-	-
Fiscal impact	0	++	+	+	+ / ++
Compliance and administration costs	0	- -	- -	- -	- -
Coherence	0	- -	- -	- / - -	- / - -
Overall assessment	0	-	-	-	-

Example key for qualitative judgements:	
++	much better than doing nothing/the status quo/counterfactual
+	better than doing nothing/the status quo/counterfactual
0	about the same as doing nothing/the status quo/counterfactual
-	worse than doing nothing/the status quo/counterfactual
- -	much worse than doing nothing/the status quo/counterfactual

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

113. Inland Revenue considers retaining the status quo to be the most desirable option. While the status quo does not improve housing affordability for first-home buyers, on balance Inland Revenue considers that the detriment produced from all four options is too great. For all four options, the compliance and administration costs for an expected 250,000 taxpayers, the decrease in housing affordability for renters, and the erosion of the coherence of the tax system outweigh the relative increase in housing affordability for first-home buyers. Limiting interest deductibility will be complex and raise fairness concerns for existing residential property investors.

114. Cabinet has, however, already (effectively) decided not to proceed with the status quo, Option 1, or Option 4. Cabinet has agreed in-principle to proceed with the interest limitation policy with an exemption for new builds, and has communicated this decision to the public. Therefore, this analysis further focuses on the option (out of remaining Options 2 and 3) that best addresses the problem and meets the policy objectives.

115. Option 3 is likely the best option relative to all options (other than the status quo). Compared to Option 2 (and Options 1 and 4), Option 3 is likely to produce the least impact on increasing the affordability of housing for first-home buyers, but it will also have the lowest impact on decreasing the affordability for renters. The marginal cost of Option 3 over Option 2 regarding price, is outweighed by the marginal benefits of rental affordability and greater fairness and coherence of the tax system. Given Option 3 has the least impact on rents, this option will minimise the impact of the proposal on those less likely to own their home relative to the general population (low-income households, younger people, Māori, and Pacific peoples).

116. Out of the four options, Option 3 will also have the smallest effect on the supply of new housing in New Zealand. While Options 2 and 3 may increase the price of housing to the detriment of owner-occupiers relative to Options 1 and 4, those building new properties will be further incentivised to build new housing stock.

117. Option 3 is preferable to Option 2 given it would not tax investors beyond their economic income where the house is taxable on sale, thereby reducing over-taxation. This is a strong fairness argument, and on balance outweighs the slightly reduced impact on housing affordability compared to Option 2. Further, Option 3

reduces the coherence of the tax system to a lesser extent overall – as it allows interest deductions in support of the general principles that expenditure incurred in business is deductible and a person should only be taxed to the extent of their income.

118. Options 2 and 3 include a new build exemption. Two details of such an exemption can be modified – the period of the new build exemption and whether it applies to only initial purchasers or to all acquirers within the period of the exemption. While there is debate and uncertainty as to the impact of a new build exemption on prices, housing supply and rents, Inland Revenue considers that a longer new build exemption (20 years) and allowing all acquirers within that period to be eligible to the exemption is preferred as it will minimise impacts on supply. Inland Revenue understands that a longer exemption is likely to mean less downward pressure on house prices. However, Inland Revenue considers that in the long run affordability is unlikely to be promoted by measures which reduce the supply of housing and for this reason supports a more generous exemption.

What are the marginal costs and benefits of Option 3?

Affected groups	Comment	Impact	Evidence Certainty
Additional costs of option 3 compared to taking no action			
Regulated groups – residential property investors	Denying interest deductions for residential investment property under Option 3 would increase the tax cost of investment property compared to the status quo. All else being equal, this would put downward pressure on demand and therefore on property prices. The impact of Option 3 on property prices would be very difficult to determine. For the marginal investor, Option 3 could be the 'tipping point,' so they would forgo the purchase or sell their existing investment property, as other alternative investments become relatively more attractive. However, if the reduced return is still expected to be the highest yielding investment (adjusted for risk) then it is rational for them to purchase or retain the property. Option 3 includes a new build exemption, and therefore residential property investors could retain current tax settings through investing only in new builds. Option 3 would also assist in some fairness concerns that arise for those who have invested or are intending to invest in existing property.	The additional tax paid by investors is expected to be $1.12 billion over the forecast period (2021/22 to 2024/25). The compliance and administration costs on residential property investors will be burdensome and be an extra cost (in addition to the tax cost). Complying with the policy would be particularly difficult for investors without tax agents or who are relatively unsophisticated. Given the policy is a shift from the fundamental tax policy principle that interest expenditure for business purposes is generally deductible, boundary issues would arise that investors would be required to navigate.	Low
Regulators – Inland Revenue	Option 3 is complex and will impose additional compliance costs on Inland Revenue. Implementation and ongoing administration demands will require Inland Revenue to undertake proactive marketing and targeted education campaigns, develop appropriate tools to assist customers to determine eligibility, improve Inland Revenue's data and analytical capability, and take audit action to address deliberate non-compliance.	The expected administration costs arising from Option 3 is estimated to be $19.38 million over the forecast period (2021/22 to 2024/5). While a significant proportion of administration costs will be incurred within the next four years, Inland Revenue will have ongoing administration costs.	Medium
Other interested party – Renters	Option 3 may put upward pressure on rents through decreasing rental supply in the long term. This means renters may be negatively impacted by the proposals. Depending on how prices react to a new build exemption under Option 3, this may lead to differences in rent for new builds compared to existing builds.	The overall change in demand (which influences the rental price), will depend on the extent to which people alter behaviour in response to the price change. This could be in the form of a transition to home-ownership (for the higher-income	Low

	Increased rents may impact tenants' living standards as it may mean that housing costs are high compared to their incomes or they are forced to live in premises that are not suitable for the number of occupants and limit their level of privacy and personal space. It may also cause crowding. Overall, this would reduce their financial and social capitals. To the extent that Option 3 places upward pressure on rents, this appears more likely to disproportionately impact low-income households, young people, Māori, and Pacific peoples, who are less likely to own their home relative to the general population. In addition, as around 43 percent of children are living in rental accommodation, upward pressure on rents could have negative impacts on child wellbeing and child poverty. Some renters may take advantage of lower house prices to become owner-occupiers. This would give them the opportunity to increase their financial and social capitals. The status quo would not provide any additional negative impacts that Option 3 may impose.	renters), a move down the housing spectrum (e.g. a younger person may move back in with their parents), or an increase in household occupancy rates to spread the rental costs over more people.	
Other interested party – current owner-occupiers	Owner-occupiers are not currently able to deduct interest expenditure from their income, therefore Option 3 will have no direct cost. However, given Option 3 is expected to (somewhat) impact house prices, the sale price that an owner-occupier could achieve if Option 3 is implemented may be lower than the sale price they could have achieved if the status quo was retained.	The impact of Option 3 on property prices would be very difficult to determine.	Low
Other interested party – macro-financial stability (including banks)	To the extent that Option 3 succeeds in reducing demand from residential property investors, this reduction in aggregate demand for residential property at the margin may reduce price pressures, all else being equal. If there was a large price impact, this may have a negative impact at the margins for banks.	The impact for banks is unquantifiable but is unlikely to be significant.	Low
Other interested party – wider government	To the extent that Option 3 results in increased pressure on rents, it may also lead to an increase in spending on the accommodation supplement and temporary additional support.	It is difficult to quantify the impact of Option 3 on wider government at this stage.	Low
Total monetised costs	We do not have confidence in the ability to provide a total monetised cost.	The expected revenue from this option (and therefore	Low

		expected cost to residential property investors) is expected to be $1.12 billion over the forecast period (2021/22 to 2024/25).	
Non-monetised costs	We do not have confidence in the ability to provide a total non-monetised cost.	Low	Low
Additional benefits of the preferred option compared to taking no action			
Other interested party – first-home buyers	At the margin, reduced competition from residential property investors in the market may reduce pressure on prices and make it somewhat easier for prospective first-home buyers to purchase a property. This would improve their financial capital and social capital (as indicated above).	It is very difficult to quantity the impact that Option 3 will have on house prices. It would depend on both the market conditions and the behaviour of market participants.	Low
Regulators – wider government	Increased revenue would be collected from the denial of interest deductions to residential property investors.	The expected revenue from this option is expected to be $1.12 billion over the forecast period (2021/22 to 2024/25).	Low
Total monetised benefits		The expected revenue from this option is expected to be $1.12 billion over the forecast period (2021/22 to 2024/25).	Low
Non-monetised benefits	We do not have confidence in the ability to provide a total non-monetised cost.	Low	Low

Section 3: Delivering an option

How will the new arrangements be implemented?

119. The new rules will be introduced through a Supplementary Order Paper before or at the Select Committee stage of the Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Bill expected to be introduced in September 2021.

120. On 23 March 2021, the Government announced its in-principle decision to deny deductions for interest expenditure on residential properties from 1 October 2021. While final policy decisions will only be released close to 1 October, the broad policy proposal has been consulted on in detail, both with the public and with advisors in the tax community.

121. Inland Revenue will be responsible for the implementation and ongoing administration of the interest limitation rules. The in-principle decisions and timeline provided by Cabinet have meant that this proposal to limit interest deductions has been progressed without comprehensive consideration of how the policy will be implemented.

122. Limiting interest deductions will involve increased administration costs for Inland Revenue over an extended period of time (especially while different rules apply during the phase-in period). This includes managing an increased number of customer contacts and supporting the integrity of the new rules. Inland Revenue will also undertake enforcement action where there is clear evidence of deliberate non-compliance.

123. Inland Revenue's initial focus will be on communication and education. It will provide information to increase awareness and support customers in meeting their obligations right from the start. This will include producing a relevant Tax Information Bulletin item, updating guidance on Inland Revenue's website, undertaking ongoing proactive marketing and targeted education campaigns, and developing appropriate tools to assist customers to determine eligibility. Any implementation or operational requirements for specific policy decisions that have not yet been made at time of writing may need to be addressed in the future. Inland Revenue expects that relatively minor alterations to systems and operations will be needed.

How will the new arrangements be monitored, evaluated, and reviewed?

124. **Monitoring:** To assist work on compliance with property transactions, Inland Revenue already includes property-related information in its Data Intelligence Platform (DIP). The DIP brings together data from different sources to provide an end-to-end view of property transactions throughout New Zealand. The DIP is being used to identify suspected cases of property non-compliance and is a searchable record of customers' past property transitions and will be further developed and enhanced to aide interest limitation compliance work. Further, Inland Revenue will report annually to Ministers on the effect of increased administration funding on taxpayers' compliance with the interest limitation rules.

125. Given the many competing influences on housing affordability, officials do not expect to be able to monitor the impact of this policy on the housing market, house prices, or rents.

126. Te Tūāpapa Kura Kāinga – Ministry of Housing and Urban Development (HUD) is responsible for the monitoring of New Zealand's housing and urban development system. As part of this role HUD collects and analyses data and research on New Zealand's housing and urban development system, including measures of housing and rental affordability.

127. Monitoring the precise impact of the interest deductibility rules on the housing and urban development system is likely to prove difficult owing to the many varied factors impacting upon the housing system. In particular, the introduction of the interest limitation rules at a similar time as the reinstatement of the Reserve Bank's loan to value ratio restrictions and proposed introduction of debt-to-income ratio restrictions (as well as possible interest rate rises) will make it difficult to specifically attribute any housing market impacts to the interest limitation rules.

128. **Review**: Inland Revenue regularly reviews tax settings on an ongoing basis and provides advice and updates to the Government accordingly. Policy officials maintain strong communication channels with stakeholders in the tax advisory community, including through the generic tax policy process, and these stakeholders will be able to correspond with officials about the operation of the new rules at any time. If problems emerge, they will be dealt with either operationally, or by way of legislative amendment if agreed by Parliament.