POLICY AND REGULATORY STEWARDSHIP

Tax policy report: Discussion document – Design of the interest limitation rules and additional bright-line rules

Date:	27 May 2021	**Priority:**	High
Security level:	In Confidence	**Report number:**	IR2021/231 T2021/1377

Action sought

	Action sought	Deadline
Minister of Finance	**Authorise** the lodgement of the attached Cabinet paper	10am Thursday 3 June 2021
Minister of Revenue	**Authorise** the lodgement of the attached Cabinet paper **Refer** report to the Minister of Housing and Associate Ministers of Housing (Public Housing and Māori Housing)	10am Thursday 3 June 2021

Contact for telephone discussion (if required)

Name	Position	Telephone
Felicity Barker	Team Leader, The Treasury	s 9(2)(a)
Chris Gillion	Policy Lead, Inland Revenue	

27 May 2021

Minister of Finance
Minister of Revenue

Interest limitation discussion document

Executive summary

Purpose

This report attaches the draft discussion document and Cabinet paper on the proposed interest limitation rules and on additional changes to the bright-line rules for your consideration. It also provides a summary of the proposals contained in the discussion document, including issues that Ministers ought to be aware of, and sets out next steps.

Context and background

On 8 March 2021, Cabinet agreed in principle to limit deductions for interest incurred on residential investment property and to exempt new builds from both the proposed interest limitation rules and the extended bright-line test (CAB-21-MIN-0045 refers). Cabinet also directed officials to consult with stakeholders on the design details of the interest limitation proposal before seeking final decisions from Cabinet.

The proposals in the attached draft discussion document are the product of consultation with private sector stakeholders via an External Reference Group (ERG) and collaboration with the Ministry of Housing and Urban Development (HUD). Although no further substantive changes to the document are being made, it continues to be fine-tuned and edited.

Decisions with major impacts on the Government's goal

Design of the interest limitation rules is complex. While the discussion document covers a lot of complexity, some key features of the proposal will impact on the extent to which the proposals impact on the Government's goal to reduce investor demand and support first home buyers, and to support housing supply in the long term. Some of the key design features and their impacts are:

- **The treatment of interest on disposal:** The discussion document presents various options as to how interest would be treated on disposal of the property. This ranges from interest always being denied, to interest being fully allowed if gains on sale are taxable. Full denial of interest, whether or not gains are taxable on sale, would increase the expected effective tax rate on leveraged investment properties the most and therefore discourage debt-financed investor activity the most. Allowing interest to be deducted on disposal where capital gains are taxable would seek to align the system more with income tax principles, by allowing expenses to be recognised when income is fully taxed.
- **The length of the new build exemption and whether it can be passed on:** A longer new build exemption, and more generous rules in regards to passing on the exemption, will result in the policy having less impact on house prices than a shorter

exemption. However, since longer exemptions have less impact on house prices, it follows that longer exemptions and allowing the exemption to be passed on to subsequent buyers could have less negative impact on housing supply than shorter exemptions.

- **Earning income from a main home:** This allows owner-occupiers who rent out part of their home to deduct interest against that income. This will support first home buyers by making entering the housing market more affordable for them.

Next steps

The discussion document is planned for release in early June after consideration by Cabinet on Tuesday 8 June. Cabinet will consider the final policy design on 27 September, and the legislation in the form of a Supplementary Order Paper is planned to be released before 1 October.

Recommended action

We recommend that you:

1. **authorise** the attached Cabinet paper and discussion document for lodgement with the Cabinet Office;

   Authorised Authorised

2. **refer** a copy of this report to the Minister of Housing, the Associate Minister of Housing (Public Housing), and the Associate Minister of Housing (Māori Housing) for their information.

   Referred/Not referred

s 9(2)(a)

Felicity Barker	**Chris Gillion**
Team Leader	Policy Lead
The Treasury	Inland Revenue

Hon Grant Robertson	**Hon David Parker**
Minister of Finance	Minister of Revenue
/ /2021	/ /2021

Purpose

1. This report attaches the draft discussion document and Cabinet paper on the proposed interest limitation rules and on additional changes to the bright-line rules for your consideration. It also provides a summary of the proposals contained in the discussion document, including issues that Ministers ought to be aware of, and sets out next steps.

Context and background

2. On 8 March 2021, Cabinet agreed in principle to limit deductions for interest incurred on residential investment property and to exempt new builds from both the proposed interest limitation rules and the extended bright-line test (CAB-21-MIN-0045 refers). Cabinet also directed officials to consult with stakeholders on the design details of the interest limitation proposal before seeking final decisions from Cabinet.

3. The proposals in the attached draft discussion document are the product of consultation with private sector stakeholders via an External Reference Group (ERG) and collaboration with the Ministry of Housing and Urban Development (HUD). Consultation with the ERG has been especially valuable in refining the proposals included in the discussion document.

4. The aim is to release the discussion document in early June after consideration by Cabinet on Tuesday 8 June. Cabinet will consider the final policy design on 27 September. The legislation in the form of a Supplementary Order Paper is planned to be released before 1 October.

5. There is significant complexity in the proposals in the discussion document, which is largely unavoidable. The discussion document contains a lot of detail about how the proposed rules could apply. This should provide more certainty to those affected by the proposals. Some aspects of the rules are complex but this is necessary given the exemptions for property development and new build properties, and the need to ensure that taxpayers cannot get around the rules by holding residential property in entities.

6. Officials are in the process of finalising the discussion document, so the document is still subject to minor editorial changes.

7. The proposals in the discussion document are summarised below. The following section also notes aspects of the proposals that Ministers should be aware of, including some potentially contentious aspects.

Proposals in the discussion document

Scope and general application of the rules

Residential property subject to the rules (chapter 2)

8. Chapter 2 outlines the intended scope of the proposed interest limitation rules. In general, the intent is that the scope of property affected by interest limitation should align as much as possible with the pre-existing definitions of “residential land” and “dwelling” in the Income Tax Act 2007 used for the purposes of the bright-line test and the residential ring-fencing rules.

9. This broadly means the proposed rules would apply to property in use as long-term residential accommodation (such as residential rental property covered by the

Residential Tenancies Act 1986) or property that is easily substitutable for long-term residential accommodation (such as homes converted into short-stay accommodation advertised predominantly on digital platforms). At the simplest level, this should include a house or apartment, regardless of whether it is used to provide long-term or short-term accommodation.

10. The chapter suggests specific exclusions from the interest limitation proposal for the following property types:

    10.1 **Employee accommodation:** Businesses provide employee accommodation for a number of reasons, including where the employment location is remote or working hours are highly variable (for example, shift work). Employee accommodation is not generally substitutable for owner-occupied housing and would not compete with regular residential property, placing it outside the scope of the Government's objectives. On this basis the draft discussion document proposes a carveout for all employee accommodation (with satisfactory integrity measures to minimise the potential for abuse).

    10.2 **Land outside New Zealand:** In accordance with a decision taken by Ministers, the draft discussion document proposes to exclude foreign properties from the interest limitation rules, regardless of whether the mortgage is denominated in New Zealand dollars or a foreign currency (IR2021/181 refers).

    10.3 **Farmland:** The definition of "residential land" used in the bright-line test specifically excludes farmland. The draft discussion document proposes adopting this exclusion for the interest limitation rules. This would mean that farmland would not be subject to the rules, even if there is a dwelling on the land that is used to provide accommodation (whether to employees or a third party).

    10.4 **Care facilities:** For instance, hospitals, convalescent homes, nursing homes, and hospices, where accommodation is incidental to the provision of care services, and is easy to distinguish from housing typically available as a private residence for owner occupiers.

    10.5 **Commercial accommodation:** There are specific types of short-term commercial accommodation that are generally relatively easy to distinguish from properties that are suitable for owner-occupation: for instance, hotels, motels, inns, hostels, boarding houses and camping grounds. Some of these facilities can be used to provide long-term accommodation (for example, emergency accommodation), but they do not generally compete with owner-occupied housing.

    10.6 **Retirement villages and rest homes:** Ministers previously decided that rest homes and retirement villages should be specifically excluded from the scope of the interest limitation proposal (IR2021/181 refers).

    10.7 **Main home:** Ministers previously decided that the interest limitation proposal would not apply to interest related to any income-earning use of an owner-occupier's main home (IR2021/181 refers). This will support housing affordability for first home buyers as well as encourage greater utilisation of housing.

11. The chapter also considers possible exclusions for certain student accommodation, serviced apartments, and Māori land, and raises how the rules might apply to dual-purpose buildings as another issue for further discussion. These issues are outlined below.

Student accommodation

12. Student accommodation (for example, halls of residence) does not compete with owner-occupied accommodation and would not typically be set up in a way that would be conducive to private owner occupation. In many situations, a specific carveout for student accommodation may not be required. However, further certainty could be provided by carving out specific types of student accommodation, such as that covered by either section 5(1)(h) or section 5B of the Residential Tenancies Act 1986.

Serviced apartments

13. Serviced apartments are apartments provided for long or short-term accommodation, with amenities provided for use. In some situations, a serviced apartment may be more akin to a hotel, but in others, the physical structure may mean that it is more like a standard residential apartment building. Unlike hotels, it is not straightforward to distinguish them from properties typically suitable for owner occupation.

14. A carveout allowing owners of serviced apartments to claim interest deductions may lead to the conversion of regular apartments into serviced apartments, which would reduce effective housing supply. However, the chapter acknowledges that a carveout for serviced apartments that more closely resemble hotels might be warranted and seeks submissions on how such a carveout might be designed to prevent standard residential apartments from being converted into serviced apartments.

Māori land and housing

15. Papakāinga and kaumātua housing have different features that may distinguish them from properties easily substitutable for owner-occupation. These may provide reasons to exclude them from the scope of the interest limitation rules. However, there are definitional issues around papakāinga and kaumātua housing, as these are not defined in legislation and some differences exist between the way in which Te Puni Kōkiri (TPK) thinks of papakāinga housing and the way in which it is more widely understood in tikanga Māori. Note that Māori entities also provide rental housing on general title land to the general public and in this case they could be treated like any other landlord on the general rental market.

16. Additionally, there are numerous permutations of how such housing is provided, including the type of legal title, ownership structures, and purposes, which create significant complexity. We are working with TPK to develop a clearer picture of the landscape of Māori housing and the most common ownership scenarios. Given the complexities, the discussion document is intended to facilitate a discussion of the relevant issues being faced, rather than to provide a concrete proposal.

Business premises and dual-purpose buildings

17. The bright-line test definition of residential land contains a carve-out for land that is predominantly used as business premises, which operates on an all-or-nothing basis: if more than 50 percent of a given property is used as business premises, it is fully excluded; if 50 percent or less is used as business premises, it is fully included. This test is deliberately simple to reduce complexity for the bright-line test, but in the context of interest limitation it may lead to harsh outcomes where interest deductions on a given property are wholly denied or wholly allowed on the basis of a few square metres or a few days.

18. The discussion document seeks feedback on whether an apportionment approach could be used for interest limitation. This proposal was of significant interest to the ERG, and it is likely to be addressed in a number of submissions.

Short-stay accommodation

19. Another potentially contentious issue is the proposed application of the interest limitation rules to short-stay accommodation. As mentioned above, the discussion document proposes (in line with the treatment under the bright-line test) to include short-stay accommodation in what would otherwise be residential houses in the scope of interest limitation, while excluding commercial accommodation like hotels (again in line with the existing rules). While this is not a departure from the present rules, it might be controversial to draw a distinction between these two different forms of short-term accommodation. However, it is important to include short-stay accommodation provided in a dwelling as it ensures there is no income tax advantage for providing short-stay accommodation versus long-term rental accommodation.

Entities affected by interest limitation (chapter 3)

Companies

20. Companies are generally allowed deductions for interest incurred, without needing to trace the use of their borrowed funds. This chapter proposes to override that general rule for close companies and residential property-rich companies so that taxpayers cannot get around the interest limitation proposal by using companies to borrow to acquire residential properties. The chapter proposes that residential property-rich companies would be those for which residential property makes up more than 50 per cent of the value of their total assets.

Kāinga Ora and other organisations

21. Kāinga Ora provides social housing but, unlike some other social housing providers, is not a charity or registered community housing provider. It therefore cannot use existing tax exemptions that are available to charities and registered community housing providers. The discussion document proposes to exclude Kāinga Ora and its wholly-owned subsidiaries from the application of the interest limitation rules.

22. It is not proposed that any other organisations will be excluded from the interest limitation rules but submissions are sought on this.

Interest subject to limitation (chapter 4)

23. Chapter 4 proposes that a tracing approach will generally be followed for the purposes of the interest limitation rules. This was previously agreed by Ministers (IR2021/133, T2021/847 refers). To work out if interest on a loan is subject to limitation, the taxpayer must trace the use of the borrowed funds. Under the proposed rules, if a taxpayer uses a loan for purposes relating to residential property (for example, to acquire the property or pay rates and insurance for the property), interest on that loan would be subject to limitation.

Pre-effective date loans

24. In our earlier joint report (IR2021/133, T2021/847 refer), we noted there may be some instances where an approach other than tracing may be needed. One such case is for pre-effective date loans (pre-ED loans), that were drawn down and used

for more than one purpose before 27 March 2021. For example, a taxpayer may have a pre-ED loan that has been used for both residential rental and other business purposes in the past, and the taxpayer may not have the records to trace retrospectively because they previously did not need to distinguish between the two purposes (all interest was deductible).

25. The discussion document suggests two possible approaches for these situations. The first approach is apportionment, where taxpayers may apportion their pre-ED loans across their assets based on their original cost. The second approach is stacking, where pre-ED loans are "stacked" against non-residential business assets first. The stacking approach would mean that if the market value of taxpayers' non-residential business assets exceeds the value of their pre-ED loans, the taxpayer gets full interest deductibility on the pre-ED loans. While this may appear quite generous, well-advised taxpayers would usually be able to achieve the same result by restructuring their affairs under tracing anyway (and it is likely to be very difficult and costly to challenge this as tax avoidance). The stacking approach has been proposed as it would avoid restructuring costs and allow less well-advised taxpayers to achieve the same tax outcomes as well-advised ones. This is also only a transitional issue.

High water mark proposal

26. Another in-principle decision taken by Cabinet was that further borrowing on or after 27 March 2021 that relates to residential properties acquired (or treated as acquired) before that date will not result in deductible interest (CAB-21-MIN-0045 refers).

27. If a borrower has a variable balance loan, such as a revolving credit facility, technically each withdrawal is new borrowing even though, over time, the balance may remain relatively constant or decline. Tracing each transaction from such an account would incur high compliance costs relative to the amount of each transaction and could incentivise inefficient behaviour. For example, taxpayers may defer principal repayments that would have otherwise been made so that money is available to spend at a later date without being new borrowing.

28. The discussion document proposes a concession to allow a borrower to make withdrawals that were traced to a pre-ED residential property without interest on that borrowing becoming immediately non-deductible, but only up to the loan balance set on 26 March 2021 (or a later date when the property is treated as acquired by that date). This is referred to in the document as the high water mark proposal. This concession will reduce compliance costs, prevent tax influencing financing decisions and will have no impact on tax deductions after the expiry of the transitional phasing period.

Disposals of property subject to interest limitation (chapter 5)

29. A question that arises concerns whether interest expense that was previously disallowed under the interest limitation rules should be deductible at the time of sale of the property. This area is the one that is most open for major policy decisions that could have a large impact on the final tax position of a rental property investor, so it is likely to attract many submissions.

30. There are a number of dimensions to this:

    30.1 **Taxable (revenue account) sales:** As all income is taxed, there is an argument that all expenses should be deductible. Cabinet recommended that officials consult on the treatment of denied interest deductions in the case of residential investment property that was held on revenue account (that is, taxable on sale) (CAB-21-MIN-0045 refers).

30.2 **Non-taxable (capital account) sales:** The capital gain on sale is not taxed, so arguably interest expense should not be deductible. However, there is an argument for deducting interest to the extent it exceeds any non-taxable capital gain. Ministers have indicated that officials may consult on whether some portion of interest may be deducted on capital account sales where appropriate.

30.3 **Gaming opportunities:** Having different rules for allowing deductions on revenue account and capital account may create opportunities to choose different treatments for different tax results.

31. The greater the extent to which an interest deduction is allowed on sale, the more an initial disallowance of the deduction is converted to a deferral of the deduction, thus reducing the overall impact on the housing market but potentially increasing fairness and tax efficiency.

32. Chapter 5 discusses these issues and options to address them.

Exemptions

Property development and related activities (chapter 6)

33. Cabinet has agreed in principle that property developers should be provided an exemption from the interest limitation rules (CAB-21-MIN-0045 refers). This will allow developers to continue deducting their interest expenses related to the development as they are incurred.

34. It would be desirable for the exemption to be wide in scope to encompass development activity which may result in the construction of a new build (as defined in chapter 7). Chapter 6 outlines that the exemption is intended to cover:

34.1 land being developed by persons in the business of developing or dealing land, or erecting buildings (captured under section CB 7 of the Income Tax Act 2007); and

34.2 other developments which may not be covered under section CB 7, for example, persons undertaking a one-off development or developing properties to rent themselves (if not already in the business of developing or dealing in land or erecting buildings).

Remediation

35. The chapter proposes that some remediation qualify for the development exemption.

36. Remediation work can take many forms and is therefore an area where it may be difficult to create clear boundaries on whether it should qualify for the development exemption. Remediation work may extend the life of older buildings or simply make a building habitable. On the other hand, those who engage in one-off renovations which do not extend the life of the building (for example, improving a kitchen or bathroom) should not be able to claim the development exemption. Excluding remediation entirely may adversely affect heritage buildings, disincentivising their restoration. This may give rise to boundary issues between what is and what is not qualifying remediation work.

New builds (chapters 7 to 9)

What is a new build? (chapter 7)

37. Cabinet has agreed in principle that a new build is exempt from the proposed interest limitation rules and that a five-year bright-line test will apply instead of the extended 10-year bright-line test (CAB-21-MIN-0045 refers).

38. Chapter 7 sets out the proposed definition of a "new build". It proposes that a property should only qualify as a new build where a self-contained dwelling (with its own kitchen and bathroom) has been added to residential land and the dwelling has received a code compliance certificate (CCC). The chapter refers to three categories of new builds: simple new builds (where a dwelling is added to bare residential land), complex new builds (where a dwelling is added to land shared with one of more existing dwellings), and commercial to residential conversions (where a commercial building is converted into one or more dwellings).

39. It is proposed that a new build would include new dwellings as well as existing dwellings that are modified so that the number of dwellings on the land has increased. This could include where an existing dwelling is converted into multiple dwellings (for example, a six-bedroom house that is converted into three townhouses), adding a relocated house to land, and converting a commercial office block into apartments. Using existing building materials is more environmentally friendly and may increase housing stock more quickly than building completely new dwellings.

40. Where an existing dwelling is replaced with one or more new dwellings it is proposed this would qualify as a new build, even if there is no increase to the number of dwellings on the land. While one-for-one replacements may not clearly increase housing stock, it would be administratively difficult to ascertain what was on the land prior to the construction of the new build, and it could be hard to enforce a rule that excludes one-for-one replacements.

41. It is proposed that existing dwellings that are renovated would not be eligible for the new build exemption, because renovations alone do not clearly increase housing supply. The chapter consults on whether there might be a way to verify that a dwelling that was previously uninhabitable has been substantially renovated so that it is of a similar standard to a new build.

Exemption from interest limitation (chapter 8)

42. Cabinet has agreed in principle to consult on how to exempt property purchased on or after 27 March 2021 and within 12 months of receiving its CCC from the proposed interest limitation rules (CAB-21-MIN-0045 refers).

43. Chapter 8 sets out the proposed design of the new build exemption from the interest limitation rules (the new build exemption). It proposes that early owners (those who acquire a new build no later than 12 months after its CCC is issued, or add a new build to their land) would be eligible for the new build exemption. This differs slightly from what Cabinet agreed, because the chapter proposes the date of acquisition be irrelevant to whether a property is considered a new build – instead what is important is whether a CCC for a new build was issued on or after 27 March 2021, and (for early owners) whether the property was acquired no later than 12 months after CCC was issued.

44. This is consistent with what Ministers agreed for new builds acquired off the plans before 27 March that receive their CCCs on or after that date (IR2021/181 refers). It means that a person who already owns land as at 27 March 2021 who decides to

add a new dwelling to the land after that date would be eligible for the new build exemption, which is consistent with the objective of increasing new housing supply.

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

Impact on house prices

45.1 **Length of the exemption:** A longer exemption allows for more interest deductions by investors. Therefore, a longer exemption will dampen house prices by less than a shorter exemption.

45.2 **Ability to pass on the exemption:** The ability to pass on the exemption to subsequent purchasers supports resale value and will dampen house prices by less than if the exemption cannot be passed on.

Impact on supply of new builds

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

46. The chapter consults on how long the exemption should apply to early owners for. Options mentioned include applying the exemption in perpetuity or for a fixed period such as 10 or 20 years.

47. The chapter consults on whether subsequent purchasers (those who acquire a new build more than 12 months after the new build's CCC is issued and within a fixed period such as 10 or 20 years from the date that CCC is issued) should qualify for the exemption. It also consults on what fixed period the exemption should apply to subsequent purchasers, should they be eligible for the exemption.

48. If the Government decides that the exemption applies to subsequent purchasers, the chapter proposes that subsequent purchasers would only be able to apply the exemption to new builds that receive their CCC on or after 27 March 2021. This differs from early owners. The Government has already announced the exemption would apply to early owners of new builds acquired on or after 27 March 2021 that received their CCCs before 27 March, provided the new build is acquired no later than 12 months after its CCC is issued. The reason for only allowing subsequent purchasers to access the exemption for new builds that receive their CCCs on or after 27 March 2021 is to make the rules simpler, so the only information a subsequent purchaser has to refer to when determining whether the exemption applies is the date a new build's CCC was issued.

49. The chapter consults on whether a new build should cease to qualify for the exemption once it has been used as a main home, regardless of whether it is rented out in the future. It also consults on whether special rules should be put in place to ensure large-scale purpose-built rental developments continue to be feasible in New Zealand.

Five-year new build bright-line test (chapter 9)

50. Cabinet has agreed that new builds will be exempt from the 10-year bright-line test and instead the existing five-year bright-line test will apply.

51. Chapter 9 sets out the proposed design of the five-year new build bright-line test. It proposes that the new build bright-line test would apply the settings of the 10-year bright-line test (such as the new time-based apportionment rule for the main home exclusion), but with a five-year bright-line period. In line with the standard bright-line test rules, the new build bright-line period would begin on the date the person receives title to the land regardless of when a new build is added. The new build must receive its CCC by the time it is sold for the new build bright-line test to apply.

Rollover relief (chapter 10)

52. Chapter 10 proposes that rollover relief would apply to transfers of residential property in certain situations for the purposes of the bright-line test and the proposed interest limitation rules.

What is rollover?

53. Rollover relief is not an exemption from income tax. Generally speaking, rollover simply defers the taxing point until there is a subsequent disposal of the property that does not qualify for rollover relief. Rollover relief essentially disregards an intervening disposal by treating the transfer as a disposal and acquisition for an amount that equals the total cost of the residential land to the transferor at the date of the transfer. For the purposes of the bright-line test, this also involves deeming the recipient to take on the transferor's original date of acquisition.

54. Limited rollover relief is currently available under the bright-line test. Rollover relief is currently only provided for residential land transferred under a relationship property agreement and for amalgamations. However, full relief is provided in relation to inherited property and it is effectively exempted from the bright-line test.

Proposals

55. In the context of the interest limitation proposal, rollover relief is being proposed to ensure that an existing property owner can still benefit from the full four-year phase-out period even if they change how they hold a property, provided there is no change in economic ownership. Rollover relief is also proposed for the interest limitation if the new build exemption is to apply to early or initial purchasers of new builds in perpetuity.

56. For the bright-line test, the proposals in this chapter would ensure that taxpayers are not brought into the bright-line test simply because they would like to settle a property on trust, for example.

57. For interest limitation, the discussion document proposes that rollover relief would be provided regardless of whether there is no consideration, partial consideration, or full consideration for the transfer of the land. However, for the bright-line test, rollover relief would be limited to situations where there is no consideration due to complexities with apportionment that would need to be accounted for.

58. As a starting point, the discussion document proposes to extend the existing relief provided for the bright-line test to the interest limitation rules (that is, for transfers under relationship property settlements, on death, and as part of a company amalgamation). It also proposes that rollover relief would be available in the following situations:

    58.1 **Natural persons disposing of land to themselves**, for example, transferring land from sole ownership to joint tenancy or from joint tenancy to tenants in common;

58.2 **Settling land on trust**, provided that: every settlor of the land is also a beneficiary of the trust; at least one of the 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;

58.3 **Transfers to or from look-through companies (LTCs)** where the persons disposing of the land to the LTC (or acquiring it from the LTC) are all shareholders in the LTC in proportion to their individual interests in the land and in proportion to their cost base relative to the total cost base in the land;

58.4 **Transfers to or from partnerships** where the persons disposing of the land (or acquiring it from the partnership) are all partners in the partnership and their respective partnership interests are in proportion to their individual interests in the land and in proportion to their cost base relative to the total cost base in the land.

59. The chapter does not seek to address all possible structures used to hold residential property, merely the most common scenarios where integrity risk is limited and focusses on structures that are likely to be used by unsophisticated investors. Officials consider that family trusts, look-through companies, and partnerships would cover a major segment of the population.

60. Stakeholders are likely to request rollover relief or a full exemption for other transactions that can result in an income tax liability arising under the bright-line test, often in the context of family arrangements where the taxpayer is not aware of the potential tax consequences of their actions.

61. For example, parents may help their children onto the property ladder by gifting them residential land or selling it to them below market value (for example, at cost). Under the Income Tax Act 2007, these transactions are deemed to occur at market value. This is an important feature of New Zealand's tax system to ensure integrity and fairness, as it provides a backstop against abuse and tax avoidance behaviour. However, it can create cash-flow difficulties when an income tax liability arises under the bright-line test.

62. These transactions are not dealt with in the discussion document due to the primary focus on the proposed interest limitation rules, and the complexity and numerous iterations of these arrangements. Any proposals would need to be carefully considered within the broader context of the tax system and ensure that the risk of abuse is minimised.

Technical issues

Interposed entities (chapter 11)

63. Chapter 11 proposes interposed entity rules to support the integrity of the interest limitation rules. Under current law, taxpayers are normally allowed interest deductions on loans used to acquires shares in a company. Without interposed entity rules, a taxpayer could claim an interest deduction for borrowings used to acquire shares in a company that owns residential property (the company is "interposed" between the shareholder's borrowing and the residential property).

64. The discussion document therefore proposes to deny interest deductions on loans used to acquire ownership interests in an entity (the "interposed entity"), if the entity holds a certain amount of residential property subject to interest limitation ("affected assets").[1] For interposed close companies and trusts, the amount of

[1] "Affected assets" would not include new builds or properties that qualify for the development exemption.

interest denied is proportionate to the amount of affected assets held, by value. For widely held interposed entities, all interest is proposed to be denied if more than 50 percent of the entity's total assets are affected assets.

65. The tax treatment under the proposed interposed entity rules is harsher in three respects than if the residential property were held directly by the borrower:

    65.1 **Full interest denial for interests in widely held interposed entities:** As noted above, it is proposed that full denial will apply for widely-held interposed entities. This may deny interest on loans partly used, indirectly, for non-residential purposes. For example, a taxpayer who borrows to acquire shares in a widely held company owning 70 percent residential rentals (old builds) and 30 percent new builds by value will be denied 100 percent of their interest expenditure, rather than 70 percent.

    65.2 **No phasing:** For all existing interposed entity structures, interest incurred by the borrower on or after 1 October 2021 will be subject to full denial.

    65.3 **Treatment on sale:** Chapter 5 outlines options for the treatment of interest expenditure when a taxpayer who directly holds residential land sells the land. Most options allow previously denied interest deductions in some circumstances (for example, if the sale is taxed). The proposed interposed entity rules do not allow previously denied interest deductions in any circumstances (for example, if the entity sells its residential land for a taxable gain). This may be perceived as inconsistent with the options suggested in Chapter 5.

66. Officials have suggested the proposed tax treatment due to simplicity. It is expected that existing interposed entity structures are not widespread. The proposed rules would create a further disincentive to use such structures.

Implications for rental loss ring-fencing (chapter 12)

67. The existing residential loss ring-fencing (RLR) rules restrict the tax benefits of residential property investments. The interest limitation rules will further reduce tax benefits from such investments. There will likely be significant interplay between the proposed interest limitation rules and the existing RLR rules.

68. Chapter 12 discusses the overlap of the RLR rules and the proposed interest limitation rules and the proposed exemptions, and the technical issues that are likely to arise. The chapter also raises the question of whether the new build exemption should be an exemption for RLR as well as interest limitation. Doing this would give greater effect to the new build exemption and simplify the interaction of the rules, but it would also reduce the tax impost on some (new build) residential property compared with the current rules.

Interaction with mixed-use asset (MUA) rules (chapter 13)

69. The focus of the proposed interest limitation rules is on debt relating to residential investment property, but they will also apply to baches and other second homes if they are used to earn income. Chapter 13 considers how the proposal will be coordinated with the existing mixed-use asset (MUA) rules, recognising that:

    69.1 the MUA rules have their own allocation rule and interposed entity rules that apply when a MUA is owned by a close company; and

    69.2 the interest limitation rule means that not all MUAs will be treated the same way in terms of interest deductibility.

Administrative impacts

70. Limiting interest deductions will 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 costs will 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 enforcement action, where there is clear evidence of deliberate non-compliance. This will involve:

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

    70.2 developing appropriate tools to assist customers to determine eligibility;

    70.3 improving our data and analytical capability; and

    70.4 taking audit action to address deliberate non-compliance.

71. Inland Revenue will work with The Treasury to consider the costs to support the administration of the rules and options to fund these changes, and will confirm this in the September Cabinet paper.

Fiscal implications

72. Limiting interest deductions will raise revenue within the forecast period and officials will provide an estimate of this revenue in the report on submissions due in early September. The report will seek final policy approval for design and include the draft Cabinet paper.

Communications

73. A communications plan is being developed between Inland Revenue and the Ministry of Housing and Urban Development. The focus is on gaining detailed feedback from professional bodies in the tax and property communities. Each agency will be contacting key stakeholders to encourage them to make a submission. The discussion document will be hosted on Inland Revenue's tax policy website, and submissions will be made by email.

74. We also expect there to be interest in what is being consulted on from owners of multiple residential properties and their tax agents. We are not planning to proactively communicate with or solicit submissions from the public. However, to help them understand the scope of the consultation we will be producing five or six summary sheets covering the main issues and pointing them to the discussion document for technical detail. We do not intend to distribute these widely, but for them to be available on the tax policy website.

75. Media queries will be directed to Inland Revenue's Policy communications staff, who will work with the relevant Ministers' Offices to coordinate responses.

Next steps

76. The discussion document will be released for public consultation in early June, with public consultation on the proposals open for five weeks. The next steps following the closing date for submissions are as follows:

- 2 September – Report on submissions and final policy approval for design with draft Cabinet paper.
- 16 September – Lodgement of Cabinet paper.
- 22 September – Consideration by the Economic Development Committee (DEV).
- 27 September – Consideration by Cabinet.
- Late September – Release of Supplementary Order Paper.