In Confidence

Minister of Finance

Minister of Housing

Minister of Revenue

Chair, Cabinet

RELEASE OF DISCUSSION DOCUMENT – DESIGN OF THE INTEREST LIMITATION AND ADDITIONAL BRIGHT-LINE RULES

Proposal

1. Cabinet previously 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. Cabinet also directed officials to consult with stakeholders on the design details before seeking final decisions from Cabinet (CAB-21-MIN-0045 refers). Attached to this paper is a draft Discussion Document on the detailed design of the rules. Minor changes may be made to the Discussion Document before it is released.

2. We intend to release the Discussion Document *Design of the interest limitation and additional bright-line rules* in June, followed by 5 weeks for consultation. The aim is for Cabinet consideration of the final policy design to occur on 27 September, and for the legislation implementing these changes to be released in late September 2021.

3. The Discussion Document consults on:

4. **Residential property affected by the interest limitation rules (chapter 2).** The chapter proposes that the rules would cover residential property located in New Zealand (excluding the family home). It outlines the issues in defining the types of property that would be impacted by the rules. The chapter proposes that a main home used to earn income would not be subject to the rules. In other words, an owner-occupier who rents out part of their home can continue to deduct interest against that rental income.

5. **Entities affected by the interest limitation rules (chapter 3).** The chapter proposes, as a starting point, that all taxpayers would be subject to the interest limitation rules. However, companies are generally allowed deductions for interest without needing to trace the use of their borrowed funds. It is proposed that the interest limitation rules would override this general rule for closely-held companies and residential investment property-rich companies, so that taxpayers cannot get around the rules by using such companies to borrow to acquire residential investment property. The chapter also proposes that the rules would not apply to Kāinga Ora and its wholly-owned subsidiaries.

6. **Interest subject to limitation (chapter 4).** Where a loan is used for a mixture of taxable and non-taxable purposes it is already necessary to trace what the loan is used for to determine deductibility (unless the borrower is a company). This chapter proposes the same approach be applied for loans used to fund residential investment property. It also covers refinancing an existing loan and transitional issues relating to debt drawn down on properties acquired before 27 March 2021.

7. **Disposals of property subject to interest limitation (chapter 5).** This chapter considers whether interest deductions should be allowed in some cases when capital gains are taxed upon the disposal of a property. Allowing interest to be deducted on disposal where capital gains are taxable would better align the rules with income tax principles, by allowing expenses to be recognised when income is fully taxed.

8. **Exemption for property development (chapter 6).** The Government has decided in-principle that property development should be exempt from the proposed interest limitation rules. This is consistent with the policy objective of increasing housing supply through the construction of new builds. This chapter considers the definition of “development” and the scope of the development exemption. It also considers options for applying the exemption to one-off developments and to land dealers.

9. **Exemption for new builds (chapters 7, 8 and 9).** The Government has decided that newly-built residential properties should be exempt from the proposed interest limitation rules, and that a 5-year bright-line test will apply to new builds instead of the extended 10-year bright-line test. Chapter 7 proposes a definition of a “new build” for these purposes. Chapter 8 considers the design of the new build exemption from the proposed interest limitation rule, including the period for which the new build exemption would apply and whether it should apply to the initial (or early) purchaser or to the property for a fixed period (such as 20 years). Chapter 9 considers the design of the five-year new build bright-line test.

10. **Rollover relief (chapter 10).** This chapter proposes some limited rollover relief to deal with transfers to trusts, as well as transfers where there is no significant change in ownership. Rollovers are disposals that are disregarded for the purposes of applying some provisions. The chapter is relevant to both the proposed interest limitation rules and the bright-line test.

11. **Technical design issues (chapters 11, 12 and 13).** Chapter 11 proposes interposed entity rules. These rules would ensure that taxpayers cannot claim interest deductions for borrowings used to acquire residential investment property indirectly through an interposed entity. Chapters 12 and 13 cover how the interest limitation rules would interact with other tax rules such as the rental loss ring-fencing rules (which restrict the tax benefits of residential investment property) and the mixed-use asset rules (which is where a property is used partly to derive income, partly for private use, and is not in use for a period of time – for example, a bach).

12. **Compliance and administration (chapter 14).** This chapter considers the administrative aspects of the proposed interest limitation rules and the changes to the bright-line test. It outlines the Government’s proposed approach to administering these changes so that the rules work, taxpayers comply with them, and the Government has sufficient information to assess their effectiveness.

Financial Implications

13. Releasing the Discussion Document will not have any fiscal implications. Any fiscal implications resulting from the proposals will be included in final policy advice to Cabinet following consultation.

Legislative Implications

14. The release of the Discussion Document will not give rise to any immediate legislative implications. Legislative changes will be necessary to implement the proposals. It is proposed that the changes are included in a Supplementary Order Paper to an omnibus taxation bill in late September 2021.

Impact Analysis

15. A RIA panel at Inland Revenue has reviewed and confirmed, the Discussion Document substitutes for an interim Regulatory Impact Statement. The Discussion Document is likely to lead to effective consultation and support the delivery of quality Regulatory Impact Analysis to inform subsequent decisions.

Population Implications

16. Releasing the Discussion Document will not have any population implications. Any population implications resulting from the proposals will be included in final policy advice to Cabinet following consultation.

Human Rights

17. The proposals contained in the Discussion Document are not inconsistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Communications

18. Communications will be undertaken by Inland Revenue, Te Tūāpapa Kura Kāinga - Ministry of Housing and Urban Development and Te Puni Kōkiri. The goal is to gain detailed feedback from the tax, property and Māori communities. Each Department will contact 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.

19. There is expected to be interest from owners of multiple residential properties and their tax agents. Officials will not proactively communicate with or solicit submissions from the public. However, to help the public understand the scope of the consultation, six summary sheets (drafts attached) will be produced covering the main issues. These will be available on Inland Revenue’s tax policy website.

20. Media enquiries to all agencies will be sent to Inland Revenue's policy communications staff, who will work with the relevant Ministers' Offices to coordinate responses.

Recommendations

The Ministers of Finance, Housing and Revenue recommend that Cabinet:

1. **note** that Cabinet directed officials to consult with stakeholders on the design details of the interest limitation and additional bright-line rules before seeking final decisions from Cabinet (CAB-21-MIN-0045);

2. **note** that a Discussion Document titled *Design of the interest limitation and additional bright-line rules* is attached for this purpose;

3. **invite** the Minister of Finance, Minister of Housing and Minister of Revenue to report back to Cabinet on the outcome of the consultation and final policy recommendations in September.

Authorised for lodgement

Hon Grant Robertson
Minister of Finance

Hon Dr Megan Woods
Minister of Housing

Hon David Parker
Minister of Revenue