POLICY AND REGULATORY STEWARDSHIP

Tax policy report: **Interest limitation on residential investment property and associated bright-line changes – final policy recommendations**

Date:	25 August 2021	**Priority:**	High
Security level:	In Confidence	**Report number:**	IR2021/341 T2021/2180

Action sought

	Action sought	Deadline
Minister of Finance	**Agree** to recommendations **Note** the contents of this report	30 August 2021
Minister of Revenue	**Agree** to recommendations **Note** the contents of this report **Refer** copies of the report to the Minister of Housing, Associate Minister of Housing (Māori Housing) and Associate Minister of Housing (Public Housing)	30 August 2021

Contact for telephone discussion (if required)

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Chris Gillion	Policy Lead, Inland Revenue	

25 August 2021

Minister of Finance
Minister of Revenue

Interest limitation on residential investment property and associated bright-line changes – final policy recommendations

Executive summary

Purpose

This report seeks your decisions on the final policy design of the interest limitation proposal.

Context and background

The most recent report to you on the interest limitation project sought some early decisions on the design of the interest limitation proposal and attached a summary of the submissions received on the discussion document *Design of the interest limitation rule and additional bright-line rules* (IR2021/325; T2021/1935 refers). Ministerial decisions on the general design and approach of the proposal have also been made on the basis of earlier reports (IR2021/133; T2021/847; and IR2021/181 refer). This report seeks your decisions on the remaining policy design issues and highlights the specific issues that are less straightforward in nature and/or are likely to be contentious.

Key policy decisions

In particular, the remaining decisions about what should and should not be included in the scope of the interest limitation proposal are not necessarily clear-cut, and the creation of various boundaries will unavoidably add to the complexity of the proposed rules. There are arguments both for and against various exclusions for types of residential property, or for types of entities that may hold residential property which need to be considered and weighed. Another area for consideration is if and how the rules are to apply to Māori collectively-owned land. It has become apparent to officials following consultation that the proposed rules as they were outlined in the discussion document may not provide the appropriate policy outcome in relation to Māori land. Therefore, some special rules or exclusions may be needed to address these specific issues.

The main issues requiring your consideration include the following:

Residential property subject to interest limitation

- Whether there will be exclusions from the interest limitation rules covering the following categories of residential property:
  - Multiple dwellings on a single title, for example, a block of flats that are all on the same legal title.

– Short-stay accommodation that is not suitable for long-term habitation by an owner-occupier or tenant (for example, a purpose-built unit that does not include standard amenities).

– Boardinghouses.

Māori collectively-owned land

- Whether the interest limitation rules should apply to Māori customary land, Māori freehold land, Crown land reserved for Māori, or land set apart as a Māori reservation, including for example papakāinga housing as well as kaumātua housing near or on a marae.
- Whether the interest limitation rules should apply to housing provided on general title land held by a Māori authority (or an entity eligible to be one) to a shareholder or beneficiary, for instance, papakāinga and kaumātua housing provided to iwi/hapū. This could include old kaumātua flats transferred to iwi and hapū by the Government.
- Whether land acquired by a Māori authority (or an entity eligible to be one) under a Te Tiriti o Waitangi – The Treaty of Waitangi (Te Tiriti) settlement or a post-Treaty settlement mechanism (for example, through a right of first refusal) should be excluded from the interest limitation rules.
- Whether different requirements for rollover relief should be provided for disposals to a trust that is a Māori authority or is eligible to be a Māori authority, or where land received as settlement of a claim under Te Tiriti by a representative is disposed of to trustees who will then manage the land for Māori claimants.

Entities specifically excluded from interest limitation

- Whether Kāinga Ora and its wholly-owned subsidiaries should be excluded from the interest limitation rules.

New build issues

- Whether the definition of "new build" for the new build exemption should also apply for the purposes of the new build bright line test. Officials recommend that "new build" be defined to mean a self-contained dwelling that is added to residential land and receives its code compliance certificate (CCC) on or after 27 March 2020.
- Whether the new build exemption will apply to existing dwellings that have been significantly remediated.
- Whether a five-year bright-line test will apply to new builds located in New Zealand that are acquired on or after 27 March 2021 and no later than 12 months after receiving their CCCs.
- Where interest expense relates to both an existing dwelling and a new build on the same title, whether an apportionment rule should apply based on existing tax principles.
- If a main home makes up more than half of a parcel of land, whether the main home exemption should apply for the purposes of both the new build bright-line and 10-year bright-line tests.
- If the main home makes up less than half of the land, whether a time-based apportionment rule should apply instead. Under such a rule, the main home portion of the land would not be taxed under the bright-line test, but the non-main home

portion of the land would be taxed if it is disposed of within the applicable bright-line period.

Fiscal implications

Officials estimate limiting interest deductions (with a 20-year new build exemption) will generate around $1.12 billion in revenue over the forecast period, although this estimate is highly uncertain. As investors are likely to increasingly reallocate to new builds, officials expect that revenues from this policy will decline from 2026. As a result, this is unlikely to provide a sustainable revenue source to fund permanent expenditure, which you should consider in the process of setting your fiscal strategy.

Next steps

Officials propose to discuss the design decisions outlined in this report with you at the regular joint Ministers' meeting on 30 August. On the basis of your decisions on these matters, we will provide you with a draft Cabinet paper on 9 September for consideration at the Economic Development Committee on 22 September.

It is intended that the amendments implementing these decisions will be included in a Supplementary Order Paper to the 2021 omnibus tax bill at the Select Committee stage. Officials are seeking your agreement in this report to consult on specific aspects of the draft legislative wording with a limited group of trusted private sector experts.

Recommended action

We recommend that you:

Residential property subject to interest limitation

1. **agree** that where a residential property and commercial property are on the same title (dual-purpose buildings), an apportionment approach based on existing tax principles should apply to exclude the commercial aspect of the property from the interest limitation rules;

   Agreed/Not agreed   Agreed/Not agreed

2. **agree** that multiple dwellings on a single title should not be excluded from the interest limitation rules;

   Agreed/Not agreed   Agreed/Not agreed

3. **agree** that short-stay accommodation should not be excluded from the interest limitation rules;

   Agreed/Not agreed   Agreed/Not agreed

4. **agree** that boardinghouses should not be excluded from the interest limitation rules, but hostels will be excluded;

   Agreed/Not agreed   Agreed/Not agreed

Māori collectively-owned land

5. **agree** that the interest limitation rules should not apply to Māori customary land, Māori freehold land, Crown land reserved for Māori, or land set apart as a Māori reservation;

   Agreed/Not agreed Agreed/Not agreed

6. **agree** that the interest limitation rules should not apply to housing provided by a Māori authority or an entity eligible to be a Māori authority to a shareholder or beneficiary of that entity;

   Agreed/Not agreed Agreed/Not agreed

7. **agree** that the interest limitation rules should not apply to land acquired by a Māori authority or entity eligible to be a Māori authority under a Treaty settlement or a post-Treaty settlement mechanism;

   Agreed/Not agreed Agreed/Not agreed

8. **agree** that rollover relief will be provided where land is disposed of to a trust that is a Māori authority, or is eligible to be a Māori authority, where the person or persons disposing of the land and the beneficiaries of the receiving trust are all either:

   8.1.1 members of the same iwi or hapū; or

   8.1.2 the descendants of any tipuna (living or dead);

   Agreed/Not agreed Agreed/Not agreed

9. **agree** that rollover relief be provided for any disposal to the trustees of a trust who, on behalf of Māori claimants, receive and manage land that is transferred by the Crown as part of the settlement of a claim under Te Tiriti;

   Agreed/Not agreed Agreed/Not agreed

Entities specifically excluded from interest limitation

10. **agree** to exclude Kāinga Ora and its wholly-owned subsidiaries from the interest limitation rules;

    Agreed/Not agreed Agreed/Not agreed

11. **agree** that if the Minister of Finance, Minister of Social Development and Employment and Minister of Housing decide to allow Kāinga Ora tenants to receive the accommodation supplement, the scope of the Kāinga Ora exemption should be re-examined;

    Agreed/Not agreed Agreed/Not agreed

12. **agree** that companies that are not close companies and not residential property-rich will be excluded from the interest limitation rules;

    Agreed/Not agreed Agreed/Not agreed

13. **agree** that a close company that is not residential property-rich will be excluded from the interest limitation rules if:

    13.1 it is a Māori Authority or eligible to be a Māori Authority; or

13.2 it is wholly owned by a Māori Authority or a trust or entity eligible to be a Māori Authority;

Agreed/Not agreed Agreed/Not agreed

14. **agree** that the residential property-rich threshold be set at 50 percent of the company's total assets;

Agreed/Not agreed Agreed/Not agreed

Interest allocation

15. agree to **ONE** of the following options for loans drawn down before 27 March 2021 that cannot be retrospectively traced:

15.1 Stacking *(recommended)*;

Agreed/Not agreed Agreed/Not agreed

OR

15.2 Apportionment;

Agreed/Not agreed Agreed/Not agreed

Development exemption

16. **agree** that the development exemption should apply to:

16.1 interest relating to land acquired for the purpose of a land-owning business (acquired for subdivision, development, dealing, and erecting buildings) that is subject to tax on sale; and

16.2 interest relating to other land that is used for subdivision, development, or erecting buildings and is intended to create a new build;

Agreed/Not agreed Agreed/Not agreed

Definition of new build

17. **note** that you have agreed that the new build exemption will apply to a new build that receives its code compliance certificate (CCC) on or after 27 March 2020 (IR2021/325; T2021/1935 refers);

18. **agree** to define a "new build" to mean a self-contained dwelling that is added to residential land and receives its CCC on or after 27 March 2020;

Agreed/Not agreed Agreed/Not agreed

19. **agree** that a new build includes:

19.1 a dwelling added to bare land, including where an existing dwelling on the land is replaced with one or more dwellings;

Agreed/Not agreed Agreed/Not agreed

19.2 a dwelling added to land that shares the same title with an existing dwelling;

Agreed/Not agreed Agreed/Not agreed

19.3 an existing dwelling that is converted into multiple self-contained dwellings;

Agreed/Not agreed Agreed/Not agreed

19.4 a commercial building that is converted into dwellings;

Agreed/Not agreed Agreed/Not agreed

New build exemption

20. **note** that you have agreed the new build exemption will apply to a new build until 20 years after the date its CCC is issued;

21. **agree** that the new build exemption will not apply to existing dwellings that have been significantly remediated (except in accordance with recommendation 19.3), but that officials will report to Ministers on options regarding remediated dwellings later this year;

Agreed/Not agreed Agreed/Not agreed

22. **agree** that an apportionment rule based on existing tax principles will apply where interest is for borrowings that relate to both an old build and a new build;

Agreed/Not agreed Agreed/Not agreed

Five-year bright-line test for new builds

23. **agree** that a five-year bright-line test will apply to new builds located in New Zealand, which are acquired on or after 27 March 2021 and no later than 12 months after receiving their CCCs;

Agreed/Not agreed Agreed/Not agreed

24. **agree** that unless there is a main home on the land, where a new build is on the same title as an existing dwelling, space-based apportionment rules will apply so that only the portion of the land attributable to the new build will be subject to the five-year new build bright-line test;

Agreed/Not agreed Agreed/Not agreed

25. **agree** that the same main home exemption will apply to both the 10-year bright-line and new build bright-line tests;

Agreed/Not agreed Agreed/Not agreed

26. **agree** to amend how the main home exemption works on a space basis for both the 10-year bright-line and new build bright-line tests, so that:

    26.1 if residential land is predominantly used as a main home, then no gains on sale will be taxed under either bright-line test (subject to the time apportionment rules referred to in recommendation 27 below); and

    26.2 if residential land is not predominantly used as a main home, then space-based apportionment rules will apply so that the portion of the land attributable to the main home is not taxed under the new build or 10-year bright-line tests (subject to the time apportionment rules referred to in recommendation 27 below);

Agreed/Not agreed Agreed/Not agreed

27. **agree** that the time apportionment rules that were introduced alongside the 10-year bright-line test, which ensure that tax is paid on a property if it has not been used as a main home for more than 12 consecutive months, will continue to apply to the 10-year bright-line test and will also apply to the five-year new-build bright-line test;

    Agreed/Not agreed　　　　Agreed/Not agreed

Interposed entities

28. **agree** that the rule for closely-held interposed entities (close companies and trusts) will apply an apportionment approach (that is, interest limited will be proportionate to the amount of affected residential property held);

    Agreed/Not agreed　　　　Agreed/Not agreed

29. **agree** that the rule for interposed entities that are non-close companies will apply an all-or-nothing approach (that is, interest is fully limited if the amount of affected residential property held is more than 50 percent of total assets);

    Agreed/Not agreed　　　　Agreed/Not agreed

Rollover relief

30. **agree** that rollover relief will apply to settlements of land on family trusts and transfers between the owners of a look-through company (LTC) or partnership and the LTC or partnership, subject to the conditions outlined in the appendix to this report;

    Agreed/Not agreed　　　　Agreed/Not agreed

Minor, technical and straightforward amendments

31. **note** that the appendix to this report contains officials' recommendations in relation to the more minor, technical, detailed or straightforward aspects of the design of the interest limitation proposal and associated bright-line changes;

Legislative implications

32. **agree** to include the above amendments in a Supplementary Order Paper to the 2021 omnibus tax bill at the Select Committee stage;

    Agreed/Not agreed　　　　Agreed/Not agreed

33. **agree** that officials may consult on specific aspects of the draft legislative wording with a limited group of trusted private sector experts;

    Agreed/Not agreed　　　　Agreed/Not agreed

Fiscal implications

34. **note** that officials estimate limiting interest deductions (with a 20-year new build exemption) will generate around $1.12 billion over the forecast period, with a corresponding impact on the operating balance and net core Crown debt, but that this estimate is highly uncertain;

Table 1: Revenue from limiting interest deductions (20-year new build exemption)

Vote Revenue Minister of Revenue	2021/22	2022/23	2023/24	2024/25
Tax revenue ($m)	80.000	200.000	350.000	490.000
Total operating	(80.000)	(200.000)	(350.000)	(490.000)

35. **note** that officials estimate that the revenue gained from limiting interest deductions will decline after 2026 as investors increasingly reallocate towards new builds, so it is unlikely to provide a sustainable revenue source to fund permanent expenditure;

Referral

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

Referred

s 9(2)(a)

Stephen Bond
Acting Manager
The Treasury

Chris Gillion
Policy Lead
Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2021

Hon David Parker
Minister of Revenue
/ /2021

Purpose

1. This report seeks your decisions on the final policy design of the interest limitation proposal.

Background

2. The most recent report to you on the interest limitation project sought some early decisions on the design of the interest limitation proposal and attached a summary of the submissions received on the discussion document *Design of the interest limitation rule and additional bright-line rules* (IR2021/325; T2021/1935 refers). Ministerial decisions and in-principle decisions by Cabinet on the general design and approach of the proposal have also been made on the basis of earlier reports. You have already made decisions on some of the key policy design features, including the following:

   2.1 Deductions for previously denied interest expense will be allowed in the year of sale of the property but only if the sale is taxable, subject to any losses being ring-fenced to taxable gains from property sales.

   2.2 Transitional, emergency and public housing will be explicitly excluded from the interest limitation rules but with a sunset clause on the exclusion.

   2.3 Qualifying new build properties will be exempt from the interest limitation rules up until 20 years from the date a new build's code compliance certificate (CCC) is issued.

3. A decision on whether purpose-built rentals (PBR) will be subject to the interest limitation rules will be sought at Cabinet.

4. This report seeks your decisions on the remaining policy design issues that have yet to be decided. The following sections set out the outstanding issues on which decisions are sought. The appendix outlines officials' recommendations in relation to the more minor, technical or straightforward aspects of the detailed design of the rules.

5. It is intended that the amendments implementing these decisions will be included in a Supplementary Order Paper to the 2021 omnibus tax bill at the Select Committee stage. Officials are seeking your agreement in this report to consult on specific aspects of the draft legislative wording with a limited group of trusted private sector experts.

Residential property subject to interest limitation

6. The interest limitation rules should apply to property that is commonly and foreseeably used to provide residential accommodation on a long-term basis, and in particular, could be used as a private owner-occupied residence. That is, the rules should apply where the physical structure is suitable for long-term residential habitation. This underlying principle is relevant to determining all properties within the scope of the rules – regardless of whether they are actually being used at any given time as owner-occupied residential property. It is their capacity to be used as such that matters.

7. The discussion document proposed using existing definitions and concepts in the Income Tax Act 2007 as a starting point. The problem is that these may lead to outcomes that do not fit with the underlying principle set out above. This inevitably leads to line calls on whether marginal cases should be inside or outside the rules.

8. The following discussion examines these issues in light of the underlying principle in relation to:

   8.1 multiple dwellings on a single title;

   8.2 short-stay accommodation;

   8.3 boardinghouses; and

   8.4 dual-purpose buildings on a single title.

Multiple dwellings on a single title

9. Submissions raised the question of multiple dwellings on a single title. This issue has some similarities with the purpose-built rentals (PBR) issue. Given broader interest in PBR, we wanted to bring these submissions to your attention. While there are some differences, in particular one of scale, both asset classes operate on similar principles.

10. A common example raised by submitters was a small block of flats with between four and 12 units. Physically, they share the same characteristics as a standard block of flats where a single flat can be purchased. The only difference is the way in which the flats are titled – legally all the flats are on a single title and must be purchased at the same time.

11. Submitters argued that these buildings should not be in scope because the dwellings are not separately unit titled. A potential buyer would have to purchase the entire building rather than a single dwelling which makes them an unlikely choice for owner-occupiers looking for an affordable home. As an asset class, submitters argued that these properties are only attractive to investors and should not be considered substitutable for owner-occupied housing.

Recommendation

12. Officials do not recommend an exclusion for these types of buildings. This is because the underlying principle is for the rules to apply to properties suitable for long-term occupation regardless of the legal structure.

13. The reference in the discussion document to the ability to use the property (or part of the property) as a private owner-occupied residence relates to whether the property could function as an owner-occupied property, not whether it is likely an owner-occupier would purchase the property. Relevant factors include whether it is self-contained or reliant on shared facilities. A conventional hotel room, for example, which is not self-contained, would not satisfy this test.

Short-stay accommodation issues

14. The discussion document sought submissions on whether certain types of short-stay accommodation should be excluded from the rules, and how an exclusion could be designed without creating an incentive for investors to convert their long-term residential rental properties into short-stay accommodation in order to circumvent the interest limitation rules. Submissions on this were mixed. Some submitted that all short-stay accommodation should be excluded from the rules regardless of suitability for long-term habitation.[1] They favoured tying this category to GST

[1] Note that by "short-stay accommodation", we mean accommodation generally advertised on digital platforms rented out as part of the so-called sharing economy. This term was misinterpreted by some submitters who suggested an exclusion for short-stay accommodation should also cover purpose-built emergency accommodation and temporary housing. This issue has been dealt with separately.

registration on the basis that an accommodation provider above the registration threshold should be regarded as a commercial business. Providers below the registration threshold would not be excluded.

15. This is unsatisfactory because the supply of accommodation is generally exempt from GST if the premises are occupied by the person as their principal place of residence (that is, long-term rental accommodation). At $300 per night, for example, a property would satisfy the GST registration threshold with an occupancy rate of only 200 nights of accommodation per year. This means that linking into the GST rules would not resolve our concerns about conversion risk as there are no structural barriers that would prevent an investor from converting a long-term rental property into short-stay accommodation.

16. Other submitters thought that properties would need to be suitable only for short-stay accommodation and that guidance would need to be developed to identify such properties.

Recommendation

17. Again, the issue comes down to the functional nature of the property itself and whether it is suitable for long term residential accommodation. Drawing a distinction based on features such as a minimum number of bedrooms in a property or units on a piece of land would be possible, but any such distinction would be arbitrary and would create boundary issues for other types of properties where submitters consider an exclusion should be available based on scale. Therefore, officials do not recommend an exclusion for short-stay accommodation at this time.

Boardinghouses

18. The discussion document proposed an exclusion for commercial accommodation predominantly designed for short-term use on a commercial basis, often at scale, on the grounds that these are straightforward to distinguish from properties that could be a private owner-occupied residence. Boardinghouses were included in this list, along with hotels, motels, and hostels. However, following submissions and further consideration, officials recommend that boardinghouses should not be specifically excluded from interest limitation.

19. In reality, boardinghouses are not straightforward to identify. Several submitters requested clarity on what is meant by the term, which is not defined in the Income Tax Act 2007 (the ITA). A similar term ("boarding house") is used in the Residential Tenancies Act 1986 (the RTA); some submitters believed that this definition would apply, and several opposed an exclusion on this basis as boardinghouses do not greatly differ from regular residential properties. It is uncertain whether the RTA definition would apply (although it is not intended to), but Inland Revenue has struggled to define "boardinghouse" for other areas of tax or clearly indicate what constitutes one. While some services need to be provided, it is unclear what the required level of servicing is, and it would ultimately depend on the specific facts and circumstances.

20. An exclusion could create an incentive to convert existing long-term rental properties into boardinghouses to circumvent interest limitation. There are few structural barriers preventing this: larger boardinghouses may be structurally similar to hostels and thus not suitable for owner-occupation, but smaller boardinghouses tend to resemble standard residential properties. Distinguishing between them is not straightforward. A distinction based on features such as a minimum number of bedrooms may be possible, but any such distinction would be arbitrary and create boundary issues for other areas where submitters consider an exclusion should be available based on scale.

21. Exclusions should provide certainty and be objectively clear for taxpayers to determine whether the rules apply to them. Officials consider that an exclusion for boardinghouses would have the opposite effect. Uncertainty could lead to non-compliance or deliberate restructuring to get around the interest limitation rules. Inland Revenue may not be able to identify these cases, particularly as New Zealand's tax system is based on self-assessment and voluntary compliance.

Recommendation

22. As there is insufficient certainty around the definition of a boardinghouse to sustain an exclusion without undermining the integrity of the rules, officials recommend that boardinghouses should not be excluded from the rules. Officials consider that many true commercial and larger-scale boardinghouses would also be covered by the term "hostel", which would be excluded. While hostel is also undefined in the ITA, officials consider there to be less risk and ambiguity.

Dual-purpose buildings on a single title – apportionment issues

23. The interest limitation rules would apply to land that has an in-scope residential property on it. It is not intended that the interest limitation rules would apply to commercial properties such as office buildings or shops. In some cases, it is possible that a commercial property and a residential property may be on the same title.

24. The bright-line test contains an exclusion for residential land that is predominantly used as business premises. This exclusion operates on an all-or-nothing basis based on predominant use (effectively a "more than 50 percent" test). If the business premises are more than 50 percent of the total residential land, they are fully excluded; if not, they are fully included. This is a simple test meant to provide certainty and reduce compliance costs for the bright-line rules. However, in the context of the proposed interest limitation rules, this could lead to harsh or arbitrary outcomes for dual-purpose buildings on a single title compared with a building where the commercial aspect is on one title and the residential accommodation on another.

25. The discussion document asked for feedback on whether the predominant use approach used for the bright-line test could be appropriate for interest limitation, or whether an apportionment approach would better achieve the intended purpose. All submitters on this issue favoured an apportionment approach and most favoured using existing tax principles.

Recommendation

26. Officials recommend an apportionment approach based on existing tax principles.

Māori collectively-owned land

Papakāinga, kaumātua and other community housing

27. The discussion document considered issues relating to housing on Māori collectively-owned land. It considered potential impacts of interest limitation on Māori and sought feedback from the public on whether papakāinga housing, kaumātua housing, or other forms of Māori community housing should be excluded from the interest limitation rules.

28. Public submissions on this issue were generally in favour of an exemption. Submitters agreed that papakāinga housing does not generally compete with housing on the regular market, making it a good candidate for an exemption. Only

one submitter specifically commented on kaumātua housing. The submitter noted kaumātua housing serves a similar purpose to retirement homes and other care facilities, and an exemption on this basis would be consistent. Some also noted that Māori are disproportionately affected by housing unaffordability and special consideration should be given to their needs. A few submitters disagreed with the proposal on the grounds that it would give preferential treatment to a particular ethnic group and may create division among New Zealanders.

29. Officials consider that certain Māori housing should be excluded from the interest limitation rules and that an exclusion can be designed without undermining the integrity of the rules.

30. There is no set definition of papakāinga housing. However, officials met with interested parties to better understand how housing is provided to whānau and whether there are any trends or certain models that are followed that might assist in developing an appropriate exclusion based on existing frameworks or tax concepts.

31. Papakāinga housing is a mix of owner-occupied housing and rental housing. Housing provided to whānau is found on both Māori land and general title land. Where the housing is on Māori land, bank lending is difficult to obtain due to the legal nature of the land. In addition, permission to reside on the land will be granted by an occupation order or a licence to occupy. Some entities are charities or community housing providers; some have elected to be Māori authorities while others have not. They can range from iwi-provided papakāinga to a few properties managed by a smaller Ahu Whenua Trust. Not all will seek expert tax advice when setting up their papakāinga and some may sit at the periphery of the tax system.

32. This means that an exclusion needs to be broad to ensure that it is not just available to those who are well advised or structure a papakāinga development in a certain way. An exclusion also needs to be robust. There needs to be minimal risk that it could be inappropriately accessed by residential property investors (for example through conversion or substitution) while also being straightforward for taxpayers to apply and for Inland Revenue to administer. Conversion and substitution of investments are less likely to occur where there is a strong regulatory framework in place and where there are limits regarding who may occupy or purchase the property.

Recommendation

33. In the first instance, officials recommend that the interest limitation rules should not apply to Māori customary land, Māori freehold land, Crown land reserved for Māori, or land set aside as a Māori reservation.[2] This would cover both papakāinga housing, as well as kaumātua housing near or on a marae. The use of and ability to reside on Māori land is subject to the provisions of the Te Ture Whenua Māori Act 1993 and the jurisdiction of the Māori Land Court. Due to the strong regulatory framework in place, property investors would not be able to convert general title land to Māori land simply to avoid the application of the interest limitation rules. Māori land is not substitutable for a residential investment property on general title land as it is not straightforward to purchase or invest in Māori land and it is difficult to secure bank lending against Māori land.

34. Due to limitations regarding use, officials also understand that it is uncommon for housing on Māori land to be rented to the general population in a commercial rental arrangement. Officials are therefore satisfied that the risk of this limb of the exclusion applying too broadly is low.

[2] Not all of this land will have residential property on it and so would be outside the scope of the rules regardless, but an exclusion would provide certainty.

35. Given that papakāinga housing can be on general title land, officials also recommend that the interest limitation rules should not apply to housing provided by a Māori authority (or an entity eligible to be one but which has not made the relevant election) to a shareholder or beneficiary of that Māori authority (or eligible entity). This limb of the exclusion is more complex because a Māori organisation may hold rental properties as a property investor. In this situation, the interest limitation rules should apply. It is for this reason that officials recommend an additional requirement that the housing must be provided to a beneficiary or shareholder for that residential property to be excluded from the scope of the interest limitation rules. This should limit the scope of the exclusion to members of an iwi, hapū or whānau, but would cover both papakāinga and kaumātua housing.

Treaty settlements

36. Property investors are generally able to sell their investments when an investment is no longer financially viable. It is expected that some property owners will sell their existing residential properties because of the interest limitation rules. This is not necessarily undesirable as it is a natural consequence of the Government's objective to tilt the playing field towards owner-occupiers and first home buyers.

37. However, this may not be an appropriate outcome in the context of a Te Tiriti o Waitangi – The Treaty of Waitangi (Te Tiriti) settlement, given the role of Treaty settlements in acknowledging and addressing Crown breaches of Te Tiriti. It may not be appropriate to expect Treaty settlement land to be sold if it is no longer economically viable because of the interest limitation rules.

38. A related issue is the use of ground leases by Māori authorities and entities eligible to be Māori authorities. You agreed that ground lessors should not be excluded from the scope of the interest limitation rules (IR2021/325; T2021/1935 refers). That report noted that special consideration should be given to the use of ground leases by Māori authorities or entities eligible to be Māori authorities. This is particularly relevant in the Treaty settlement context where ground leases are not uncommon due to the nature of the land. The land may not be able to be sold, or due to the cultural significance it may not be appropriate to sell it. However, it may not be economic or within the landowner's broader strategy to become an active residential landlord. Therefore, to ensure productive use of the land, a ground lease structure with a term of 99 or more years, for example, may be one of the few options available. Particularly in the case of existing ground leases, it would not be possible for the ground lessor to exit/cancel the ground lease.

Recommendation

39. Officials therefore recommend that land acquired by a Māori authority (or entity eligible to be one) under a Treaty settlement or a post-Treaty settlement mechanism (for example, through a right of first refusal) should also be excluded from the interest limitation rules. This should include land that is subsequently transferred by the post-settlement governance entity to members of the claimant group. If land is then sold commercially to a third party, the new owner should be subject to the rules.

40. In the context of ground leases, this exclusion should apply to the ground lessor (being the Māori authority or eligible entity that owns the Treaty settlement land) but not to the lessee. That is, where a property investor holds a leasehold interest in a residential property on Treaty settlement land, they should still be subject to the interest limitation rules as this investment would be substitutable for other residential investment property.

41. The proposal addresses an additional equity concern that may arise between iwi groups – those that have already settled would otherwise be impacted by the

interest limitation rules, whereas iwi groups that are still in negotiations could either seek additional redress for the tax impact or seek other remedies via tax indemnities from the Crown. For the latter, both remedies are complex and could have downstream implications. It may therefore be simpler to exclude Treaty settlement property from the scope of the rules.

42. Officials have consulted with a number of interested parties, including some iwi and hapū, who have expressed support for these proposals.

Rollover relief for disposals to Māori land trusts

43. The discussion document sought additional feedback on whether specific rollover relief provisions would need to be designed for collectively-owned Māori land to ensure that the interest limitation rules and bright-line test operate as intended.

44. Our consultation on the rollover relief proposal for land held collectively by Māori through trusts (both Māori land and general land owned by Māori subject to the Te Ture Whenua Māori Act 1993) indicated that a specific provision of rollover relief may be useful in the most likely types of restructuring scenarios.

Recommendation

45. In addition to the proposal for general family trusts (which could apply for all types of trusts), officials recommend that rollover relief be provided where:

    45.1 the land is disposed of to a trust that is a Māori authority, or is eligible to be a Māori authority; and

    45.2 the person or persons disposing of the land and the beneficiaries of the receiving trust are all:

        45.2.1 members of the same iwi or hapū; or

        45.2.2 the descendants of any tipuna (living or dead).

46. The bright-line test may also be too broad in the context of settlements under Te Tiriti. Where land is received as settlement of a claim under Te Tiriti by a representative and is disposed of within the relevant bright-line period to a trust for Māori claimants (for example, where it is transferred from the post-settlement governance entity to hapū), the disposal may be subject to the bright-line test. Therefore, officials also recommend that rollover relief be provided for any disposal of land to the trustees of a trust who, on behalf of Māori claimants, receive and manage land that is transferred by the Crown as part of the settlement of a claim under Te Tiriti.

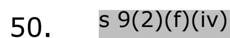
Entities specifically excluded from interest limitation

47. In general, when determining who and what should be subject to the interest limitation rules, officials have preferred exclusions on a property basis over an entity basis. This is because entities may hold different assets for different purposes. For example, a taxpayer that operates a retirement village could also hold many residential rental properties. Excluding retirement village operators on an entity basis would therefore also exclude those ordinary rental properties from the interest limitation rules, contrary to the policy intent.

48. Officials have only recommended two entity-based exclusions, both of which are largely for compliance cost reasons.

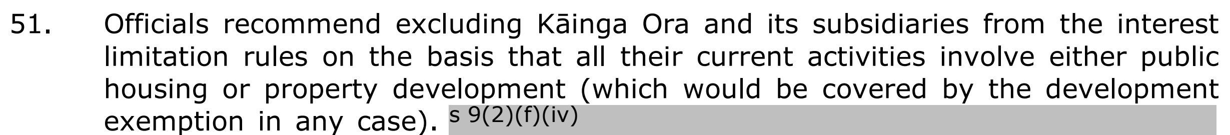
Kāinga Ora and its wholly-owned subsidiaries

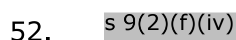
49. The discussion document proposed to exclude Kāinga Ora and its subsidiaries from the interest limitation rules. Some submitters argued that this exclusion would give Kāinga Ora a tax advantage, which officials disagree with. Instead, the exclusion would ensure the tax treatment of Kāinga Ora under the interest limitation rules is the same as for other taxpayers. Registered community housing providers and registered charities are usually exempt from income tax and will therefore be unaffected by interest limitation. Kāinga Ora also provides public housing, but under law it cannot be a registered community housing provider[3] and it is unlikely[4] that Kāinga Ora, as a Crown agency can be registered as a charity, notwithstanding that it carries out the same activities as many charities that provide community housing.

50. 
s 9(2)(f)(iv)

Recommendation

51. Officials recommend excluding Kāinga Ora and its subsidiaries from the interest limitation rules on the basis that all their current activities involve either public housing or property development (which would be covered by the development exemption in any case). s 9(2)(f)(iv)



52. 
s 9(2)(f)(iv)

Non-close companies that are not residential property-rich

53. You have previously agreed that the discussion document would include the option of not applying the interest limitation rules to companies that are not close companies nor residential property-rich (IR2021/133; T2021/847 refers). The purpose of this proposed exclusion is to minimise compliance costs for companies whose core business does not involve residential property but who may still hold some residential property. An example is a company that buys bare land intending to use it as business premises. Until that land is used as business premises it could still be considered "residential property" if zoning rules allow a dwelling to be built on it. Such companies would usually be able to achieve the same tax outcome by allocating debt to their other business asset, but this can have high compliance costs. Officials therefore recommend excluding companies whose residential property is less than 50 percent of the value of their total assets.

54. A 50 percent threshold is consistent with the existing "residential land-rich" threshold in the loss ring-fencing rules. Companies will only be excluded if they stay below this threshold at all times in the income year. However, most companies

[3] The definition of "community housing provider" in section 2 of the Public and Community Housing Management Act 1992 explicitly excludes Kāinga Ora.
[4] The law is not entirely clear on this and a Crown Law opinion would be required to confirm it.

whose core business does not involve residential property will be well below the threshold, so will not have to constantly monitor their residential property percentages.

Recommendation

55. Officials also recommend extending this exclusion to close companies that are Māori authorities (or eligible to be a Māori authority) or wholly-owned subsidiaries of Māori authorities (or of entities eligible to be Māori authorities), provided the close company is not residential property-rich. The reason officials initially suggested applying the rules to all close companies was because close companies are controlled by one or a small number of individuals so the potential for avoidance is higher. However, a company that is a Māori authority or owned by a Māori authority will often technically be a "close company" because it is owned by a single trust, even though the trust itself may have many (sometimes thousands of) beneficial owners.[5] In substance, most Māori authorities are more akin to widely-held companies than to close companies. The potential for avoidance is also low, as an individual cannot easily set up a Māori authority to hold their ordinary rental property.

Interest allocation (transitional issue)

56. Taxpayers may not be able to retrospectively trace some loans that were drawn down before 27 March 2021. This may occur even if a taxpayer has complied with all their legal record-keeping obligations, because previously they did not need to trace whether their borrowings were applied to residential property or to other business purposes. Taxpayers have always needed to trace borrowings applied to private purposes (such as buying a family home) so the options listed below would not apply to these "private" loans.

57. The discussion document consulted on two options for bringing these pre-27 March loans into the interest limitation rules:

    57.1 **Stacking**. Under this option, the pre-27 March loans are allocated first to the market value of the taxpayer's other business assets before being allocated to residential property.

    57.2 **Apportionment**. Under this option, pre-27 March loans are apportioned across the taxpayer's residential and other business assets based on the assets' costs.

58. The vast majority of submitters preferred stacking, with several submitters wanting the option of being able to choose between the two. Officials consider that allowing taxpayers to choose between stacking and apportionment would create undue complexity and recommend against it.

Recommendation

59. Officials recommend stacking on the basis that it is fairest for taxpayers and would significantly lower compliance costs. Well-advised taxpayers would be able to restructure to achieve the same tax outcome as would be achieved using stacking anyway, and most of these restructures would be very difficult to detect and challenge. Moreover, this transitional rule would only affect pre-27 March loans so

[5] There are restrictions on Māori Authorities to ensure they are representative of, and accountable to, their members. Similar restrictions do not apply to ordinary discretionary trusts. An ordinary discretionary trust could therefore have thousands of beneficiaries, but only ever make distributions to a small number of its beneficiaries.

its impact will be limited. Stacking is also more consistent with Ministers' desire not to affect loans for other business purposes when compared with apportionment.

Loss ring-fencing

60. Many submitters have asked that loss ring-fencing be repealed in light of interest limitation. Loss ring-fencing prevents residential property investors from offsetting losses from property investments against their other income. Given the proposed limitation of interest deductions, loss ring-fencing could be considered much less relevant and repealing it would simplify the taxation of property. However, because interest will remain deductible for investments in new builds, retaining loss ring-fencing for new builds may have some merit. To retain or repeal the loss ring-fencing rules is a fundamental issue and officials have not been in a position to properly consider the issue.

Recommendation

61. Officials recommend retaining loss ring-fencing at this stage. The issue may be raised again by submitters when the legislation is considered by the Finance and Expenditure Committee and officials will report to you as part of that process.

Development exemption

62. As decided by Cabinet, officials have consulted on an exemption for interest incurred by an owner of residential land used for development. We recommend that:

    62.1 interest incurred with respect to land acquired for use in a land-owning business of development, subdivision, dealing or erecting buildings be covered by the development exemption; and

    62.2 the exemption also be available for interest incurred in relation to other land used for development, subdivision or erecting buildings for the purpose of creating one or more new builds (as defined below).

63. Issues regarding remediated property are discussed at paragraphs 68 to 72 below.

Definition of new build

64. You have agreed that new builds which receive their CCCs on or after 27 March 2020 would qualify for the new build exemption until 20 years from the date of the CCC (IR2021/325; T2021/1935 refers). The exemption would generally apply from the date a CCC is issued for a person who adds a new build to their land, or from the date of acquisition where a person acquires a new build that already has its CCC.

65. For the five-year new build bright-line test, a new build would have to be acquired on or after 27 March 2021, and would need to have its CCC by the time it is disposed of. It would also need to be acquired no later than 12 months after the new build receives its CCC because, unlike the exemption from interest limitation, the bright-line test only applies to the initial owner of a new build.

66. To ensure the rules for new builds are as simple as possible, officials recommend the same definition of new build apply for both the new build exemption from interest limitation (new build exemption) and the new build bright-line test.

Recommendation

67. A property should generally only qualify as a new build where there is an increase in residential housing supply. Officials recommend that "new build" be defined to mean a self-contained dwelling that is added to residential land and receives its CCC on or after 27 March 2020.

68. It would not matter whether a dwelling is made from brand new materials, or whether the dwelling is constructed on-site. It would therefore include modular homes and relocated dwellings. The definition would include the types of new builds set out in the discussion document, which submitters generally supported. These include:

    68.1 **Simple new builds**, which is where a new build is added to bare land. It includes where an existing dwelling on the land is replaced with one or more new dwellings.

    68.2 **Complex new builds**, which is where a new build is added to land but shares the same title with an existing dwelling. The dwellings do not have to be on separate titles. The new build can be standalone, or attached to the existing dwelling (added above, below or beside the existing dwelling).

    68.3 **Multi-dwelling conversions**, which is where an existing dwelling is converted into multiple self-contained dwellings. For example, a two-story single unit dwelling is converted so the two floors become two separate self-contained dwellings. Both of these units would be considered new builds.

    68.4 **Commercial to residential conversions**, which is where a commercial building is converted into dwellings.

Remediation and uninhabitable dwellings

69. The discussion document asked submitters whether remediation work (including significant renovations of uninhabitable dwellings) should make an existing dwelling eligible for the new build exemption. Many submissions on this issue were in favour of providing an exemption for existing dwellings that have been remediated.

70. Properties that are owned and remediated by a professional developer or dealer will generally qualify for the development exemption for the period they are owned by the developer or dealer. However, the development exemption would not apply for remediation work performed if the owner of the land is not a professional developer or dealer. For example, if a taxpayer is not in the business of development or dealing and they contract another party to remediate a property that they own, then that remediated property would not qualify for the development exemption.

71. If remediated dwellings were to qualify, what qualifies would have to be clearly defined given the rules would impact many New Zealanders. "Remediation" could encompass anything from a simple renovation, such as adding a new room to a dwelling, to extensive renovations undertaken to remediate a leaky or earthquake-prone building. Alternatively, any house that was previously "uninhabitable" could qualify once it has undergone remediation and become habitable again. Depending on which remediated dwellings qualify, the rules could create perverse incentives. For example, if an uninhabitable dwelling qualifies after remediation, this could incentivise property investors to leave existing dwellings to deteriorate so that they qualify as "uninhabitable" before then remediating them.

72. Just as the definition of new build is tied to CCCs, it is important that whether a remediated dwelling qualifies is objectively verifiable. If not, there is a risk that allowing remediated dwellings to qualify could undermine the objective of the interest limitation rules, by providing property investors with a way to bring

additional existing dwellings within the scope of the new build exemption without necessarily creating new housing stock.

Recommendation

73. Officials recommend that neither exemption applies to existing dwellings that are remediated at this stage (except to the extent remediation by a dealer or developer would qualify under the development exemption). We will continue to undertake policy work on how best to include some remediated existing dwellings within the scope of the development and new build exemptions without undermining broader policy objectives.

New build and existing dwelling on same title

74. The new build exemption and the five-year new build bright-line test would apply to residential land that has a new build on it:

    74.1 The exemption would allow any interest that relates to a new build to be deducted. This includes interest on borrowings to acquire residential land that a new build is on; to construct a new build; or to fund other expenses such as maintenance, rates, or insurance.

    74.2 Under the five-year new build bright-line test, the new build would only be taxed on sale under the bright-line test if it is disposed of within five years of acquisition.

75. Where a new build and an existing dwelling are on the same title, there is a need for some rules to ensure that only the new build benefits from both the new build exemption from interest limitation and the five-year new build bright-line test.

Recommendation

76. Where interest relates to both an existing dwelling and a new build (such as where a loan covers the cost of acquiring land that has both an existing dwelling and a new build on it) then officials recommend applying an apportionment rule based on existing tax principles. The interest attributable to the new build would be deductible provided there is sufficient nexus with an income earning activity. The interest attributable to the existing dwelling would not be deductible because the interest limitation rules would apply.

77. Where a new build and an existing dwelling on residential land acquired on or after 27 March 2021 are on the same title, officials recommend that only the portion of the land with the new build on it would be subject to the five-year new build bright-line test. The 10-year bright-line test would apply to the portion of the land with the existing dwelling on it. This means that if land with a new build and an existing dwelling on it is sold seven years after acquisition, the new build portion would not be taxed under the new build bright-line test but the old build portion would be taxed under the 10-year bright-line test. Existing tax principles for apportionment would apply.

Changes to the main home exemption from the bright-line test

78. The main home exemption currently applies where more than half the land is used as a main home (this is referred to as a space-based predominance test). This means that under current law, the main home exemption can result in the main home being subject to tax where less than half of the land is used as a main home. For example, if two rental properties were built on the same title as a main home

and those rental properties took up more than half the land, then the main home exemption would not apply. Gains on the rental properties and the main home would be taxed if the land was sold within the applicable bright-line period.

79. A 10-year bright-line test is significantly longer than five years. Extending the test in this way makes it more likely that main homes will be taxed on sale where they make up less than half of the land (because the main home exemption, in its current form, would not apply).

Recommendation

80. Officials recommend the following rules apply under the new build and 10-year bright-line tests in relation to a main home on residential land:

    80.1 If a main home makes up more than half of the land, then the main home exemption would apply in accordance with the current law. Any gain on sale would not be taxed under the new build bright-line or 10-year bright-line tests.

    80.2 If the main home exemption does not apply because the main home makes up less than half of the land, an apportionment test would apply instead. Under the apportionment test, the main home portion of the land would not be taxed under the bright-line test, but the non-main home portion of the land would be taxed if it is disposed of within the applicable bright-line period.

81. Overall, these changes would ensure that a main home is never taxed under the new build or 10-year bright-line tests while it is being used as a main home. A person who builds a granny flat on the same section as their main home would continue to benefit from the main home exemption. The main home would also not be taxed even where the portion of the land used as a main home is smaller than the non-main home portion.

Interposed entities

82. Interposed entity rules ensure that taxpayers who borrow to acquire residential property indirectly are still subject to interest limitation. The rules are inevitably complex, but submitters generally agreed that there is a need for such rules.

83. An interposed entity may or may not be closely held. Close companies and trusts would be considered closely-held entities. Taxpayers who have an ownership interest in a closely-held entity will usually be able to access information about that entity's assets without much difficulty. Moreover, closely-held interposed entities usually have fewer assets, and their assets are less likely to change significantly over the course of an income year. It is also more likely that taxpayers will try to use closely-held interposed entities for tax avoidance (in the absence of interposed entity rules).

Recommendation

84. Officials therefore recommend having a different rule for closely-held interposed entities (that is, close companies and trusts) than for other interposed entities. In broad terms, the two rules would work as follows:

    84.1 For closely-held interposed entities, the rule would be more accurate in that it would apply an apportionment approach. The amount of interest limited under the rule would be proportionate to the amount of residential property (excluding new builds and development property) held by the interposed entity.

84.2 For other interposed entities, the rule would be simpler and apply an "all-or-nothing" approach. If more than 50 percent of the value of an interposed entity's assets are residential property (excluding new builds and development property), 100 percent of the taxpayer's interest deductions traced to the interposed entity would be denied.

Rollover relief

85. The discussion document proposed limited rollover relief for both the proposed new interest limitation rules and the bright-line test.

86. Rollover simply ignores a transaction for tax purposes. In the context of the bright-line rules, this means that the transaction does not trigger the bright-line test. Currently, only limited rollover relief is available under the bright-line test for relationship property and company amalgamations. The discussion document proposed limited extensions to bright-line rollover (which were also proposed to apply for interest limitation purposes) for settlements of land on family trusts or transfers between the owners of a look-through company (LTC) or partnership and the LTC or partnership. Submitters wanted the proposed relief to be extended much further to associated persons transactions more generally. This is a significant change which raises a number of integrity concerns that would need to be considered and which cannot be done in the limited time available.

Recommendation

87. For the reasons outlined above, officials do not recommend extending rollover relief beyond the situations outlined in the discussion document, aside from the extensions recommended in relation to Māori land at paragraphs 42 to 45 and the changes described in the appendix.

Fiscal implications

88. Officials estimate limiting interest deductions (with a 20-year new build exemption) will generate around $1.12 billion over the forecast period as indicated in Table 1 below. This updates the estimate The Treasury provided in T2021/967 and incorporates your design decisions for the policy, including providing a 20-year exemption for new builds.

Table 1: Revenue from limiting interest deductions (20-year new build exemption)

Vote Revenue **Minister of Revenue**	**2021/22**	**2022/23**	**2023/24**	**2024/25**
Tax revenue ($m)	80.000	200.000	350.000	490.000
Total operating	(80.000)	(200.000)	(350.000)	(490.000)

89. This estimate is highly uncertain because:

89.1 It incorporates behavioural assumptions about how residential property investors will react to the policy.

89.2 It incorporates the interaction between the interest limitation policy, rental loss ring-fencing, and the rules which tax residential property on sale, such as the bright-line test (as interest deductions are allowed on the taxable sale of properties). These interactions are uncertain, as these policies are relatively recent and there is limited data to draw on.

89.3 There are data limitations regarding the total amount of interest investors are currently deducting, and future interest rates and housing market conditions.

90. The most significant assumption officials have made is that residential property investors will increasingly reallocate their residential investments towards new builds. This significantly decreases the revenue from interest limitation, including reducing revenue by approximately $300 million in the 2024/25 year.

91. Officials expect that the revenue gained from limiting interest deductions will peak at approximately $650 million in 2026 and then decline as investors increasingly reallocate towards new builds. The declining revenue from limiting interest deductions means it is unlikely to provide a sustainable revenue source to fund permanent expenditure. The Treasury therefore recommends that you factor this likely decline into account when you set your wider fiscal strategy and do not look to fund additional permanent spending from additional short-term revenues.

Administrative implications

92. Inland Revenue will be responsible for implementing and administering the changes and will require additional funding to do so. Officials are in the process of developing an estimate of the additional costs and considering funding options for discussion with The Treasury. These will be provided with the draft Cabinet paper in early September. Given the complexity of the new rules, the wide variety of taxpayers affected and the short timeframe for implementation, the main focus will initially be on communication of the changes, education and using our analytical capabilities to full effect.

93. 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 follow-up action, where there is clear evidence of deliberate non-compliance. This will involve:

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

93.2 developing appropriate tools to assist customers to determine eligibility;

93.3 improving our data and analytical capability; and

93.4 taking audit action to address deliberate non-compliance.

Next steps

94. Officials propose to discuss the design decisions outlined in this report with you at the regular joint Ministers' meeting on 30 August. Once you have made decisions on the final policy design, we will provide you with a draft Cabinet paper and Supplementary Analysis Report on 9 September. The other relevant dates for Cabinet approval of the policy and the release of the Supplementary Order Paper (SOP) to the 2021 omnibus tax bill are as follows:

Lodgement of the Cabinet paper with the Cabinet Office	16 September
Consideration at DEV Committee	22 September
Cabinet approval of policy and delegation to release SOP	27 September
Public release of SOP	28 September
Finance and Expenditure Committee calls for submissions on the SOP	29 September
Submissions on the SOP close	10 November

Appendix – Detailed and technical issues

The table outlines officials' recommendations for the more minor, technical or straightforward aspects of the detailed design of the interest limitation proposal.

Topic	Recommendations
Residential property subject to interest limitation	• That employee accommodation should be exempted from interest limitation where it meets the definitions in the residential ring-fencing rules, as proposed in the discussion document. • That student accommodation should be exempted from interest limitation, based on the regulatory framework provided by the Residential Tenancies Act 1986. • That serviced apartments, as defined in the Income Tax Act 2007, should not be specifically exempted from interest limitation.
Entities affected by interest limitation	• That, in applying the rules to close companies, the existing definition of close company should be used without amendment at this stage to minimise the potential impact on other areas of tax. • That a company would be considered residential property-rich for the income year if it exceeds the residential property-rich threshold at any time during the income year. • That, in determining whether a taxpayer is residential property-rich: – the value of property subject to the development exemption will be subtracted from the value of residential property to ensure that developer companies are not affected by the rules; – the value of property subject to the new build exemption will not be subtracted from the value of residential property; – shares in a residential property-rich company will be treated as residential property to avoid the need to look through chains of company; and – the test will be applied on a wholly-owned group basis, with intra-group shares and loans (that is shares in, or loans to, another member of the wholly-owned group) disregarded in order to avoid double counting. • That, in determining whether a taxpayer is residential property-rich, asset values are determined using: – for residential property, including improvements to the land, but excluding property subject to the development exemption, the later of: ▪ the property's most recent capital value or annual value as set by a local authority; or ▪ either the cost of the property on acquisition or, if the transaction involves an associated person, its market value; – for all other assets (including property subject to the development exemption): ▪ the value in the taxpayer's financial statements, if those statements are prepared in accordance with either generally accepted accounting principles, or minimum requirements prescribed by an Order in Council made under section 21C of the Tax Administration Act 1994; ▪ in all other cases, the asset's tax value.

Interest allocation	• That interest on loans that fund property situated outside New Zealand will not be covered by the rules.
Disposals of property subject to interest limitation	• If interest has been denied under interest limitation, and the property is sold in a taxable (revenue account) sale, that the denied interest is potentially deductible in the year of sale. • If the sale is on revenue account because it is a bright-line sale, that the interest is treated as if it were an additional cost of the property, deductible in the year of sale (and not subject to loss ring-fencing), but the net loss from sale (including the interest amount) is deductible only to the extent of gains from the sale of the property, and other property, in the same income year or a later income year.
Development and related activities	• That the development exemption will apply on a property-by-property basis and will apply to: – interest on property that is held on revenue account under section CB 7 of the Income Tax Act 2007, from the date of acquisition; and – interest on other property used for development, subdivision and/or erecting buildings with the aim of creating a new build (by non-CB 7 taxpayers), from the commencement of the development activity. • That the development exemption will apply until the earlier of the date a code of compliance certificate is issued or when the property is sold or disposed of.
Definition of new build	• That where a hotel/motel unit is converted to a dwelling but no CCC is required, the dwelling would qualify as a new build from the date council records show the change in use took place.
New build exemption from interest limitation	• That the new build exemption applies from the date of acquisition for new builds acquired off the plans, but the 20-year fixed period is still counted from the date a new build's CCC is issued. • That the new build exemption ceases from the earlier of the date a new build ceases to be on the land it was added to or 20 years from the date the new build receives its CCC, to ensure the exemption only applies if there is a new build on the land. • That if a new build's CCC is issued subject to a B2 modification (which generally occurs when a CCC is issued more than five years after building work is substantially completed, and means that a building's durability is measured from the date of substantial completion instead of the date it receives its CCC), the 20-year fixed period the new build exemption applies for is not counted from the date the new build's CCC is issued, but instead from the date the building work for the new build was substantially completed.
New build bright-line test	• That the settings that apply for the 10-year bright-line test also apply for the five-year new build bright-line test (noting that officials have recommended changes to how the main home exclusion works for both the 10-year and new build bright-line tests).
Rollover relief	• That rollover relief (for interest limitation and bright-line purposes) will apply to settlements of residential property on a family trust (or sales to a family trust), provided that: – every settlor (or seller) of the land is also a beneficiary of the trust; – at least one of the settlors (or sellers) of the land is also a principal settlor of the trust; and

	– every beneficiary, except for the beneficiaries who are also principal settlors, has a family connection with a principal settlor (generally a person within 4 degrees of relationship of a principal settlor, or a company that person controls, or a trust of which they are a beneficiary) or is a charity. • That rollover relief (for interest limitation and for bright-line purposes) will apply to transfers to or from look-through companies (LTCs) and partnerships where the persons disposing of the land to the LTC/partnership (or acquiring it from the LTC/partnership) have ownership/partnership interests in the LTC/partnership in proportion to: – their individual interests in the land; and – their cost base relative to the total cost base in the land. • That bright-line rollover for settlements on family trusts and for transfers to or from LTCs or partnerships will only apply provided that the amount of consideration is less than or equal to the vendor's acquisition cost and the other conditions outlined above are met (as applicable). • That for a transfer of the type described directly above except the amount of consideration exceeds the vendor's acquisition cost, the amount of taxable income to the vendor under the bright-line test will be the actual amount of consideration instead of the market value of the land. • That interest limitation rollover relief will also apply to transfers under relationship property agreements, transfers of inherited property upon the death of the owner, and transfers as part of company amalgamations. This mirrors the existing relief available for the bright-line test. • That transfers of land to effect a change in co-ownership do not reset the bright-line clock to the extent that they do not increase a person's proportional or notional proportional interest in the land.
Interposed entities	• That, to minimise compliance costs, the interposed entity rule for close companies and trusts will only apply when the value of residential property subject to limitation comprises at least 10 percent of the interposed entity's total assets. • That the interposed entity rule for non-close companies will only apply when the value of residential property subject to limitation comprises at least 50 percent of its total assets. • That the apportionment calculation required under the interposed entity rule for close companies and trusts is to be calculated on a quarterly basis. • That, for the purposes of the interposed entity rules, asset values are determined using: – for residential property, including any improvements to the land, the later of: ▪ the property's recent capital value or annual value as set by a local authority; or ▪ either the cost of the property on acquisition or, if the transaction involves an associated person, its market value; – for all other assets: ▪ the value in the interposed entity's financial statements, if those statements are prepared in accordance with either generally accepted accounting principles, or minimum

	requirements prescribed by an Order in Council made under section 21C of the Tax Administration Act 1994; – in all other cases, the asset's tax value. • That the mixed-use asset rules are to apply in priority to the interest limitation rules for a mixed-use asset that is also residential property. • That, if interest has been allocated to a mixed-use asset that is also residential property, the asset will be excluded from the calculations required under the interposed entity rules. • That there will be a specific anti-avoidance rule to address arrangements where asset values are deliberately increased or decreased to defeat the intent and application of the interposed entities rules. • That there will be a specific anti-avoidance rule to address arrangements involving persons (and their associates) borrowing and on-lending to their interposed entities at a lower interest rate. • That look-through companies (LTCs) and partnerships should not be treated as interposed entities as they are transparent for tax purposes. • That when a person uses borrowed money to acquire an ownership interest in an LTC or partnership, the person is treated as borrowing the money to acquire an interest in any residential property owned by the LTC or partnership (in proportion to the person's effective look-through interest or partnership share). • That when a person has used borrowed money to acquire an ownership interest in an interposed company, and the company later becomes an LTC, the person is to continue applying the close company and trusts interposed entity rule to the interest expenditure on the pre-election loan even after the company becomes an LTC. • That, for simplicity, interest expenditure incurred after 1 October 2021 on money borrowed to acquire an ownership interest in an interposed entity before 27 March 2021 will be subject to full limitation instead of the four-year phasing period. • That, for simplicity, a person who uses borrowed money to acquire an ownership interest in an interposed entity will not be allowed a deduction for their interest expenditure when the person no longer holds an interest in the interposed entity, even if the ownership interest was sold for a taxable gain.
Implications for the rental loss ring-fencing rules	• That interest limitation applies before loss ring-fencing. • That interest limitation applies on a property-by-property basis only, notwithstanding that loss ring-fencing can apply on either (or both) a property-by-property or a portfolio basis.
Interest limitation and mixed-use property	• That when a loan is traced to a residential investment property, or to shares in a close company/qualifying company that owns a residential investment property, and the property is used to derive income and partly for private use: – the mixed-use asset rules in subpart DG are to apply to apportion the interest incurred in the income year between the income earning use and the private use; – the amount apportioned to private use is not allowed as a deduction; and

	– the amount apportioned to the income earning use is not allowed as a deduction under the interest limitation rule (and may be allowed as a deduction on a taxable sale of the property in the income year of sale). • That rules be enacted to achieve the above policy, including technical rules relating to the interaction of the mixed-use asset rules and the interest limitation rules.