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Te Tari Taake

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Special report on interest limitation and additional bright-line rules

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This special report provides early information on the interest limitation rules and bright-line changes made in the Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Act ahead of an upcoming edition of the *Tax Information Bulletin*.

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Overview

The Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Bill was introduced into Parliament on 8 September 2021. It received its first reading on 23 September 2021, second reading on 8 March 2022, and its third reading on 29 March 2022. This was followed by Royal assent on 30 March 2022.

The interest limitation rules and bright-line changes were first introduced by way of Supplementary Order Paper No. 64 on 28 September 2021.

Interest limitation

The interest limitation rules are part of the Government's initiatives to address housing affordability. The aim of the reform is to reduce investor demand for residential property.

Many landlords invest in residential property expecting a large capital gain when they sell the property. The tax system previously allowed landlords to deduct interest expenditure for residential rental property, even if gains made on sale of the property were not taxed. The new interest limitation rules have limited the deductibility of interest expenses incurred by property investors from 1 October 2021. The extent of the limitation depends on whether the property was acquired on or after 27 March 2021.

Summary of key features:

- **Disallowed residential property subject to interest limitation:** Property that is commonly and foreseeably used to provide residential accommodation on a long-term basis and is (or could be) used as an owner-occupied residence is subject to the interest limitation rules. This property is referred to as disallowed residential property (DRP). From 1 October 2021, deductions are denied for interest incurred in deriving income from DRP acquired on or after 27 March 2021 (subject to certain exceptions).
- **Application to certain companies:** The provision allowing for an automatic deduction of interest for most companies is overridden for certain close companies and companies whose assets are primarily DRP. These companies are now required to trace the use of their borrowed funds and are denied deductions for interest incurred on borrowings used to derive income from DRP.
- **Excepted residential land excluded from DRP:** Certain types of property not suitable for long-term residential accommodation, and which cannot be substituted for such, are excluded from DRP and not subject to the interest limitation rules.

- **Exemptions:** Land businesses, developments and new builds are exempt from the interest limitation rules. New builds are exempt for a period of 20 years from their date of completion.
- **Grandparented residential interest subject to progressive limitation:** For DRP acquired before 27 March 2021, deductions for interest are being progressively denied over the transition period between 1 October 2021 and 31 March 2025. DRP owners are required to trace the use of their borrowed funds to ensure the limitation is applied to interest incurred on borrowings used to derive income from the DRP. The current tracing approach applies for loans used to fund DRP – that is, tracing funds borrowed to taxable and non-taxable purposes to determine the deductibility of interest on a loan (unless the borrower is a company). This includes borrowings to fund expenses incurred in deriving income from the DRP, for example, interest on borrowings to pay a rental property's rates (although the deductibility of the underlying rates expenditure is not affected by the interest limitation rules).
- **Rollover relief for transfers of DRP:** Rollover relief is provided for certain transfers or disposals of DRP to ensure grandparented residential interest remains deductible throughout the full transition period between 1 October 2021 and 31 March 2025.
- **Interest deductions on taxable sale of the DRP:** Interest deductions are allowed on the taxable sale of the DRP.
- **Interposed entities:** Interposed entity rules ensure taxpayers cannot claim interest deductions for borrowings used to acquire DRP indirectly through interposed entities.
- **Specific anti-avoidance rules:** Specific anti-avoidance rules support the integrity of the interest limitation rules.

Bright-line changes

As well as introducing new interest limitation rules, several changes have been made to the bright-line rules for sales of residential land.

Key changes:

- **5-year new build bright-line test:** Owners of new builds are subject to a 5-year bright-line period rather than the 10-year period.
- **Amendment to main home exclusion:** The portion of land attributable to the main home will generally not be taxed on disposal under either the 10-year or 5-year bright-line tests.

- **Rollover relief:** Limited extensions to rollover relief from the bright-line test are available for some common ownership change scenarios where economic ownership has not changed or is materially the same as it was before.

Definition of disallowed residential property

Sections DH 5(2), YA 1, and schedule 15 of the Income Tax Act 2007

The new interest limitation rules apply to "disallowed residential property", and new section DH 5(2) introduces a definition of that term. "Disallowed residential property" means land in New Zealand to the extent to which—

- it has a place configured as a residence or abode
- the owner has an arrangement to erect a residence or abode, or
- it is bare land that could be used to erect a place configured as a residence or abode.

The definition excludes land to the extent it is "excepted residential land".

Background

The new interest limitation rules in subpart DH of the Income Tax Act 2007 are intended to apply to properties that are, or could be, commonly and foreseeably used to provide long-term residential accommodation. The focus is on whether a property is physically configured or structured in such a way that could support the use of the property as a self-contained private residence. Effectively, the rule applies to property that could be used for private owner-occupation. In practice, this means most houses and apartments are subject to interest limitation unless a specific exclusion applies.

A focus on actual use as long-term residential accommodation was not considered to be appropriate. This was because property owners would be able to circumvent the rules by changing the use of the property (for example, by listing the property on a digital platform for short-stay accommodation instead) and this could impact the supply of properties available for long-term occupation (either rented or owner-occupied).

Key features

New subpart DH introduces the interest limitation rules. These rules deny an interest deduction for interest incurred for disallowed residential property on or after 1 October 2021.

New section DH 5 defines the key terms used in the interest limitation rules. The terms "disallowed residential property" (DRP) (defined in section DH 5(2)) and "excepted residential land" (defined in section DH 5(3) and new schedule 15) provide the scope of property subject to interest limitation.

The definition of DRP covers any land in New Zealand to the extent to which it has a place configured as a residence or abode, the owner has an arrangement to erect such a place, or it is bare land on which such a place could be erected. Note that the definition applies to structures that *could be* used as a residence or abode. Whether they *are* used as such is not considered by the definition.

Excepted residential land is excluded from being DRP. Excepted residential land is described in new schedule 15 of the Income Tax Act 2007.

Where a single parcel of land contains both a place configured as a residence or abode and a structure that is listed in schedule 15 as being excepted residential land, apportionment principles apply to exclude the part that is excepted residential land. This means that the interest limitation rules only apply to the portion of the land that relates to the residence or abode.

Application date

The provisions came into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Detailed analysis

Disallowed residential property

New section DH 5(2)(a) defines "disallowed residential property" as land in New Zealand to the extent to which:

- it has a place configured as a residence or abode, regardless of whether it is used as such (subparagraph (i))
- the owner has an arrangement that relates to erecting a place configured as a residence or abode there, regardless of whether that place is, or is to be, used as such (subparagraph (ii)), or

- it is bare land that, under rules in the relevant operative district plan, may be used for erecting a place configured as a residence or abode there, regardless of whether that place is, or is to be, used as such (paragraph (a)(iii)).

In each case, it includes any appurtenances belonging to or enjoyed with the place.[1]

DRP does not cover residential properties that are not in New Zealand. Foreign residential properties are therefore not subject to interest limitation under subpart DH.

Note that while the definition of DRP is similar to the definitions of "residential land" and "dwelling" used for other purposes in the Income Tax Act 2007, each of the terms serve distinct purposes. The interest limitation rules are a standalone regime and therefore differences between the definitions are intended.

DRP does not include land to the extent it is "excepted residential land" (section DH 5(2)(b)). Standard apportionment principles apply to ensure that the part of a residential property that qualifies as "excepted residential land" is not subject to interest limitation.

Excepted residential land

"Excepted residential land" is defined in new section DH 5(3) as land to the extent to which it is described in new schedule 15. The contents of schedule 15 are described in more detail in the "Excepted residential land – schedule 15" section of this special report.

Use of the phrase "to the extent" means that where a given parcel of land or property is partly DRP and partly "excepted residential land", a reasonable apportionment must be made according to general tax apportionment principles. This is usually only relevant where the different structures are on the same legal title. Where they are on separate legal titles, the accompanying loans may be structured separately, making it more straightforward to distinguish between interest that relates to excepted residential land and interest that relates to the DRP.

[1] A common example of an appurtenance is a driveway or path.

Example 1: Dual purpose land and interest limitation

Tāmati owns a two-storey building with mixed residential and commercial use, which he acquired before 27 March 2021. The ground floor is a clothing store, and the top floor is rented out as long-term residential accommodation.

The whole building is on a single legal title. Tāmati has one loan that relates to the whole property.

Tāmati's building is DRP to the extent it is configured as a residence or abode and to the extent it is not excepted residential land. The top-floor apartment is DRP, but the clothing store on the ground floor is not.

Following standard principles for apportionment, Tāmati calculates that the clothing store accounts for 55% of the interest paid on his loan and the residential rental property accounts for the remaining 45%. Therefore, Tāmati is subject to interest limitation under subpart DH for 45% of his interest expenses, as this is interest that relates to DRP.

For the period from 1 October 2021 to 31 March 2025, an increasing portion of that 45% of his interest expenses is denied in accordance with the table in section DH 8(2). From 1 April 2025, no deduction is available for any of that 45% of his interest expenses relating to the DRP.

Change in use during income year

The use of a property may change during the income year. Depending on the circumstances, this may lead to a change in status from DRP to excepted residential land, or vice versa. In these cases, some of the owner's interest deductions relating to the property will be denied or limited under subpart DH and some will be unaffected by subpart DH, depending on when the interest is incurred.

This could occur, for example, when an owner-occupier moves out of their residential property partway through the year and they rent the property out instead of selling it. The property no longer qualifies for the main home exception in schedule 15[2], and any interest incurred from that point is subject to interest limitation under subpart DH.

[2] See discussion of the main home exception in the "Excepted residential land – schedule 15" section of this special report.

Similarly, a person could move into their rental property. While it is a rental property, it is DRP and subject to interest limitation under subpart DH. When it becomes the person's main home, it becomes excepted residential land and is no longer subject to subpart DH. This means that some interest may be deductible if they use their main home to earn income (for example, if they have a flatmate or rent out a spare room for short-stay accommodation).

Taxpayers therefore need to determine whether the property was DRP or excepted residential land at the time the interest is incurred to ascertain whether that interest expense is subject to denial under subpart DH.

For further information on how this works during the transition period (1 October 2021 – 31 March 2025), see the "Grandparented residential interest" section of this special report.

Example 2: Change of status during income year

Grace owns a two-bedroom house in Tauranga with a mortgage. Grace is a standard balance date taxpayer, so her income year is 1 April to 31 March.

From 1 April 2026 until 29 September 2026, Grace lives in the house and rents out the spare bedroom to help cover the cost of her mortgage. During this period, the property is considered excepted residential land, as it is covered by the main home exception in clause 7 of schedule 15. Grace can claim some of the interest on her mortgage as an expense against the rental income from her flatmate. She calculates that, based on the size of the property and the use of communal areas, 30% of her interest expense is deductible while she has a flatmate.

In September, Grace receives a job offer that requires her to move to Christchurch, and from 29 September 2026, the property is rented out and no longer her main home. This means that, from 29 September 2026, the property is no longer excepted residential land; it is now disallowed residential property. Because it is DRP, her interest expense is subject to interest limitation under subpart DH. Grace can no longer claim any mortgage interest as a deduction against her rental income.

Grace's mortgage interest is incurred monthly. For the month of September, the property is DRP for 2/30 days and excepted residential land for 28/30 days. Grace determines the impact of the interest limitation rules on her Tauranga property for the 2025-26 income year as follows:

Month	Total interest	Classification	Result under subpart DH
April	$600	Excepted residential land	No interest limitation under subpart DH, but only 30% is deductible according to Grace's apportionment of areas used by her flatmate.
May	$590		
June	$580		
July	$570		
August	$560		
September	$550	Excepted residential land for 28 days Disallowed residential property for 2 days	$513.33 (being $550 x 28/30) is not subject to interest limitation under subpart DH. Only 30% of $513.33, being $154, is deductible according to Grace's apportionment calculation. $36.67 (being $550 x 2/30) is subject to interest limitation and denied under subpart DH.
October	$540	Disallowed residential property	All of Grace's interest expense is subject to interest limitation and is denied a deduction under subpart DH.
November	$530		
December	$520		
January	$510		
February	$500		
March	$490		

Social, emergency, transitional, and council housing

Sections DH 4(4), (5) and (6) of the Income Tax Act 2007

Land used to provide social, emergency, transitional and council housing is exempted from the interest limitation rules.

Background

Social housing is accommodation provided at low or no cost to individuals, families and whānau who have an income below a specific threshold and are unable to afford or access housing at current market prices. It also aims to support people who are experiencing homelessness or who are at risk of homelessness. Social housing can take a variety of forms, depending on the level and type of need. Types of housing offered include public housing owned by Kāinga Ora–Homes and Communities (Kāinga Ora), housing offered at below market rent by registered community housing providers (CHPs), or council housing provided by local authorities. It also includes emergency housing and transitional housing that is provided to people in need while they seek, or are assisted in finding, more permanent accommodation. For most types of social housing, the cost to the individual, family and whānau is calculated according to their household income. Without a specific carve-out, a number of properties used for emergency, transitional, public or council housing could otherwise be subject to interest limitation.

Social housing plays an important role in providing accommodation for low-income people in New Zealand. The carve out for social housing in its various forms ensures that the supply of social housing is not disrupted because these properties are withdrawn from the market.

Key features

New sections DH 4(4)-(6) provide that the interest limitation rules do not apply to:

- interest incurred for a property used exclusively by a registered community housing provider (CHP), Kāinga Ora–Homes and Communities (Kāinga Ora), or another government department to provide social, emergency or transitional housing
- interest incurred in relation to a property used exclusively by a local authority or council-controlled organisation (CCO) to provide council housing, and
- Kāinga Ora and its wholly-owned subsidiaries.

Application date

The new provisions came into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Detailed analysis

Social, emergency, and transitional housing

New section DH 4(4) specifies that subpart DH does not apply to interest incurred by a person for land to the extent to which the land is used for the specified forms of housing by:

- a registered community housing provider under the Public and Community Housing Management Act 1992
- Kāinga Ora or a wholly-owned subsidiary of Kāinga Ora, or
- a government department listed in schedule 2, part 1 of the Public Service Act 2020.[3]

To qualify for the exemption, the property must be used by one of the above entities solely for one or more of the following specified forms of housing for people in need:

- "social housing" as defined in section 2 of the Public and Community Housing Management Act 1992 (section DH 4(4)(a))
- temporary accommodation for people in need while they seek, or are assisted in finding, more permanent accommodation (section DH 4(4)(b))
- other accommodation for people in need (section DH 4(4)(c)), or
- services connected with such housing or accommodation (section DH 4(4)(d)).

Section DH 4(4)(c) is intended to cover accommodation provided by a government department that is not otherwise covered by paragraphs (a) or (b). This includes, for example, housing used by Oranga Tamariki to provide accommodation for tamariki and rangatahi.

Section DH 4(4)(d) exempts services connected with housing or accommodation described in paragraphs (a) to (c). This ensures a residential property that also provides wraparound services (such as onsite counselling or therapy) is not inappropriately disqualified from being eligible for the exemption.

The exemption only applies to the extent to which a given property is used

[3] Available at https://legislation.govt.nz/act/public/2020/0040/latest/LMS106159.html

- by one of the entities listed in section DH 4(4) (a qualifying entity)
- for one or more of the purposes listed in sections DH 4(4)(a) to (d).

If a property satisfies one of these conditions but not the other, it is still subject to interest limitation. For example, if a house is rented out by a community housing provider at normal market rent and not as social housing, the property would not meet the requirement of being provided for a purpose listed in sections DH 4(4)(a) to (d), and the exemption from the interest limitation rules would not apply.

The entity that owns or rents the property does not need to be the same entity that provides the social, emergency or transitional housing. For example, one entity may be responsible for managing the property portfolio, but it may contract out the client relationship to another entity. In this case, the exemption would still be available.

A taxpayer who leases their property to a qualifying entity for a purpose listed in paragraphs (a) to (d) can qualify for the exemption for the duration of the lease, even if they are not a qualifying entity themselves and have no interaction with the individual tenant. However, the exemption does not apply to private property owners who lease their properties directly to low-income tenants, such as tenants in receipt of an accommodation supplement.

The social housing exemption applies on a property-by-property basis. If there are multiple buildings on a single piece of land (residential or commercial) and only one of the buildings is used for social, emergency or transitional housing, the exemption is only available for that particular property. The person claiming the interest deductions may need to apportion their interest expense accordingly.

In addition, the whole property must be used for one or more of the purposes described in paragraphs (a) to (d) to qualify for the exemption. If only one room in a property is rented by a qualifying entity and the other rooms are rented to third parties, the exemption would not apply.

The exemption covers periods of vacancy between social housing tenants if the property continues to be under lease to a qualifying entity during that time. In the case of social housing, the definition in the Public and Community Housing Act 1992 includes premises that are "to be let" as community housing by a CHP or as Kāinga Ora housing.

In contrast, if a disallowed residential property is occasionally rented by a qualifying entity to provide emergency or transitional housing, but no exclusive lease exists for the property, periods of vacancy would not be covered by the exemption.

Example 3: Registered community housing providers and periods of vacancy

Olivia owns a house in Christchurch and leases it to the Chan Community Housing Trust (CCH Trust), a registered community housing provider, for use as social housing. The lease is for a fixed period of three years starting from 1 July 2021.

From 1 October 2021 until 7 June 2022, the CCH Trust rents the house as social housing to Jason. Jason moves out of the house on 7 June 2022. The house is temporarily vacant while the CCH Trust prepares it for another social housing tenant to move in. On 1 August 2022, the CCH Trust begins renting the house as social housing to Rosemary.

Olivia's Christchurch property is exempt from the interest limitation rules while it is under lease to the CCH Trust. This includes the period it is vacant from 8 June 2022 to 31 July 2022.

Example 4: Property occasionally rented by community housing provider

Kris owns a house in the Bay of Plenty that is occasionally rented by a community housing provider when the provider requires emergency or transitional housing for its clients. The booking arrangement is on a casual basis and is dependent on the availability of the property, as the property can also be booked by members of the public for short-stay accommodation.

During the 2022–23 tax year, the house is rented by the community housing provider for the provision of emergency or transitional housing from 16 June to 31 August and again from 28 October to 17 November. For the remainder of the year, it is either rented by members of the public or not rented by anyone and vacant.

For the 2022–23 tax year, Kris only qualifies for the social housing exemption for interest incurred from 16 June to 31 August and from 28 October to 17 November.

Council housing

Many local authorities around New Zealand provide council housing, similar to social, emergency or transitional housing, at below market rates. While local authorities are generally exempt from income tax under section CW 39 of the Income Tax Act 2007, the properties may be owned by taxable council-controlled organisations (CCOs).

New section DH 4(5) specifies that subpart DH does not apply to interest incurred for land to the extent the land is used by a CCO or a local authority solely for:

- housing for people assessed by a local authority as being eligible for housing at less than market rent (paragraph (a)),
- services connected with such housing (paragraph (b)).

Section DH 4(5)(b) ensures that, as with the social, emergency, and transitional housing exclusion in section DH 4(4), the provision of wraparound services in connection with council housing does not disqualify a property from being eligible for the exemption. In many situations, such services are not provided in a building that is configured as a residence or abode, but paragraph (b) puts the issue beyond doubt.

Interest incurred on a property would still be subject to interest limitation if the land is used by a local authority or CCO but not used for council housing – for example, if a CCO provides rental housing at market rates.

A private landlord who leases their property to a local authority or CCO for the provision of council housing can qualify for the exemption for the duration of the lease, even though they are not a local authority or CCO themselves and have no interaction with the individual tenant. However, the exemption does not apply to private property owners who lease their properties directly to low-income tenants.

As with the social, emergency, and transitional housing exemption, the whole property must be used for council housing (including services provided in connection with council housing) to qualify for the exemption. If only one room in a property is rented by a local authority or CCO and the other rooms are rented to third-party individuals, the exemption in section DH 4(5) would not apply.

Note that this exemption uses the definition of "council-controlled organisation" provided in section 6 of the Local Government Act 2002,[4] rather than the definition given in section YA 1 of the Income Tax Act 2007.

Application to companies

Sections DH 3, DH 5(4), (8), (9), (10) and (11) of the Income Tax Act 2007

The interest limitation rules apply to all companies whose main business involves disallowed residential property (DRP) (other than DRP subject to the land business or development

[4] https://legislation.govt.nz/act/public/2002/0084/latest/contents.html

exemptions) and to most close companies that hold DRP. Companies that are not close companies and whose main business does not involve DRP are generally not subject to the rules.

If the interest limitation rules apply to a company, it must trace its borrowings to identify interest it has incurred for DRP. It is denied a deduction for that interest unless an exemption applies.

Key features

The interest limitation rules apply to a company that is a:

- residential land company
- residential land wholly-owned group member, or
- close company that is not an exempt Māori company.

Residential land companies and residential land wholly-owned group members

The interest limitation rules apply to companies that are residential land companies and not part of a wholly-owned group. If a company is part of a wholly-owned group, the rules apply if the company is a residential land wholly-owned group member.

A "residential land company" is a company where the combined value of its DRP (excluding DRP subject to the land business or development exemptions) and the shares it holds in other residential land companies makes up more than 50 percent of the value of its total assets.

A "residential land wholly-owned group member" is a member of a wholly-owned group where the combined value of the group's DRP (again excluding DRP subject to the land business or development exemptions) and the shares the group holds in non-group companies that are residential land companies makes up more than 50 percent of the value of the group's total assets.

Close companies

The interest limitation rules apply to close companies that incur interest for DRP unless the company is an exempt Māori company. In general terms, a "close company" is a company controlled by five or fewer natural persons or trustees as shareholders.

A close company (other than an exempt Māori company) does not have to consider the amount of DRP held as a percentage of its total assets. If it holds any DRP and incurs interest for that DRP, the interest limitation rules apply to the company. It is required to trace its borrowings and is denied deductions for interest incurred for DRP unless an exemption applies.

Exempt Māori companies

An exempt Māori company is a company that:

- is a Māori authority or is eligible to be a Māori authority, or
- is wholly-owned by a Māori authority or by a company or trust that is eligible to be a Māori authority, and
- is not a "residential land company" (if it is not a member of a wholly-owned group) or a "residential land wholly-owned group member" (if it is a member of a wholly-owned group).

A Māori authority is a trustee or a certain type of company with the obligation to administer assets communally owned by Māori.

The exclusion for an "exempt Māori company" recognises that, while an exempt Māori company may legally be a close company, it is, in substance, a company for the benefit of, and accountable to, a very large number of individuals. In terms of control and governance, an exempt Māori company is very different to a typical close company.

Application date

The new provisions came into force on 27 March 2021 with application to companies incurring interest on or after 1 October 2021.

Detailed analysis

Relationship between sections DB 7 and DB 8 and new section DH 3

Section DB 7 provides that most companies are allowed deductions for interest incurred without having to trace their borrowings and establish a nexus between the interest incurred and assessable or excluded income.

Section DB 8 provides that companies are generally allowed deductions for interest incurred on money borrowed to acquire shares in another company that is part of the same group.

New section DH 3 sets out when the interest limitation rules in subpart DH apply to companies.

Subpart DH overrides sections DB 7 and DB 8. If section DH 3 provides that the subpart applies to a company, that company must apply the interest limitation rules and not sections DB 7 or DB 8.

When subpart DH applies to companies (section DH 3)

Section DH 3 sets out when the interest limitation rules in subpart DH apply to companies.

Section DH 3(a) specifies that the interest limitation rules apply to close companies that are not exempt Māori companies. A "close company" is (in general terms) a company controlled by five or fewer natural persons or trustees as shareholders.

Sections DH 3(b) and (c) specify when the interest limitation rules apply to companies that are not close companies. If a company is not a member of a wholly-owned group, section DH 3(b) provides that the interest limitation rules apply if the company is a residential land company. If a company is a member of a wholly-owned group, section DH 3(c) provides that the interest limitation rules apply if it is a residential land wholly-owned group member.

If a company is required to apply the interest limitation rules, it must trace its borrowings to identify any interest it has incurred for DRP, and it is denied a deduction for that interest unless an exemption applies.

To understand how the rules apply to companies, it is helpful to consider first how the rules apply to residential land companies and residential land wholly-owned companies.

Residential land companies

If a company is not a close company and is not a member of a "wholly-owned group", it will only have to apply the interest limitation rules if it is a "residential land company" (section DH 3(b)).

The term "residential land company" is defined in section DH 5(8). A company is a "residential land company" if at any time during the income year the company has a ratio equal to or greater than 50 percent calculated using the following formula:

$$\text{(disqualified property + indirect disqualified property)} \div \text{total assets}$$

To apply the formula, the value of a company's disqualified property, indirect disqualified property, and total assets must be determined.

The items in the formula are defined in section DH 5(9), and their values are determined under the valuation rules in section DH 12.

Disqualified property

"Disqualified property" is defined in section DH 5(9)(a) as the value of the company's DRP, excluding DRP subject to the land business or development exemptions in sections DH 4(2) and (3) respectively. The exclusion of DRP subject to these exemptions is to reduce compliance costs for companies who hold land for the purposes of dealing, development, subdivision, or building.[5]

However, "disqualified property" *does* include DRP that is subject to the new build exemption in section DH 4(1). This is for two reasons.

- First, a company whose main business is residential rental may hold DRP that is a mixture of new builds and old builds. If "disqualified property" excluded new build DRP, a company could hold slightly more new builds than old builds (say 51 percent new builds by value) so that the company would not have to apply the interest limitation rules and would be allowed a deduction for all its interest costs under section DB 7. This is inappropriate, as the rules are intended to apply to companies whose main business is residential rental.
- Second, the new build exemption is time-restricted to twenty years. A company that started out holding mostly new builds may, over time, end up holding mostly old builds. If new builds were excluded from the definition of "disqualified property", such a company would not have to apply the interest limitation rules initially but would have to apply them at a later point. This may prove difficult, or even impossible, unless the company had traced its borrowings from the start.

Indirect disqualified property

"Indirect disqualified property" is defined in section DH 5(9)(b) as the value of shares that the company holds in other companies that are residential land companies. This ensures that companies cannot circumvent the interest limitation rules by holding DRP indirectly through other companies.

To save compliance costs, "indirect disqualified property" does not require companies to look through chains of companies to work out the precise amount of disqualified property

[5] For detailed analysis on the exemptions, see the "Exemptions for new housing supply – overview" and following sections of this special report.

held indirectly. Companies only need to consider the value of any shares they hold in other companies that are residential land companies.

Total assets

"Total assets" is defined in section DH 5(9)(c) as the total value of the company's assets.

Example 5: Residential land company

A Ltd's total assets consist of the following:

- DRP with a value of $400,000.
- Other business property with a value of $500,000.
- 50 percent of the shares in B Ltd with a value of $300,000.

To determine if A Ltd is a residential land company, A Ltd has to apply the formula in section DH 5(8):

(disqualified property + indirect disqualified property) ÷ total assets

A Ltd's disqualified property is $400,000, being the value of its DRP. However, to determine if A Ltd has indirect disqualified property, it must determine whether B Ltd is a residential land company.

B Ltd's total assets consist of the following:

- DRP with a value of $400,000.
- Other business property with a value of $200,000.

Applying the above formula to B Ltd, the value of B Ltd's disqualified property as a percentage of its total assets is 66.7% (being $400,000/$600,000). B Ltd is therefore a residential land company.

A Ltd must therefore include the value of its shares in B Ltd ($300,000) as indirect disqualified property in the above formula.

The value of A Ltd's disqualified property and indirect disqualified property as a percentage of its total assets is therefore 58.3% (($400,000 + $300,000)/$1,200,000). A Ltd is therefore also a residential land company.

Residential land wholly-owned group member

If a company with DRP is not a close company and is a member of a wholly-owned group, it must apply the interest limitation rules if it is a "residential wholly-owned group member" (section DH 3(c)).

The term "wholly-owned group" is defined in section YA 1. It has the same meaning as the term "wholly-owned group of companies", which is defined in section IC 4. In general terms, a "wholly-owned group of companies" means two or more companies in relation to which a group of persons holds common voting interests that add up to 100 percent.

"Residential land wholly-owned group member" is defined in section DH 5(10). The definition is similar to the definition of a "residential land company" in section DH 5(8), but the formula is applied on a consolidated basis. A company is a "residential land wholly-owned group member" if it is a member of a wholly-owned group of companies and, at any time during the income year, the group has a ratio equal to or greater than 50 percent calculated using the following formula:

(disqualified property + indirect disqualified property) ÷ total assets

The items in the formula are defined in section DH 5(11), and the values for those items are determined under the valuation rules in section DH 12.

"Disqualified property" is defined in section DH 5(11)(a) as the value, on a consolidated basis, of the wholly-owned group's DRP, excluding DRP subject to the land business or development exemptions in sections DH 4(2) and (3). The reasons for excluding DRP subject to the land business or development exemptions, but not the new build exemption, are the same as those outlined above for residential land companies.

"Indirect disqualified property" is defined in section DH 5(11)(b) as the value of shares that the wholly-owned group holds in non-group companies that are residential land companies.

"Total assets" is defined in section DH 5(11)(c) as the total value, on a consolidated basis, of the wholly-owned group's assets.

The requirement in the definitions of "disqualified property" and "total assets" to value these items on a consolidated basis is to prevent intra-group shares and loans being doubled counted.

Example 6: Residential land wholly-owned group – intra-group assets

Land Group is a wholly-owned group of companies with the following members and assets:

Holding Co (a non-close company)			
Assets	**$**	**Liabilities**	**$**
Shares in A Co	4m	Bonds	3m
Shares in B Co	6m	Equity	
		Shareholder capital	7m
Total	**10m**	**Total**	**10m**

A Co			
Assets	**$**	**Liabilities**	**$**
DRP	2m	None	
Other business property	1.5m	**Equity**	
Loan to B Co	0.5m	Shareholder capital	4m
Total	**4m**	**Total**	**4m**

B Co			
Assets	**$**	**Liabilities**	**$**
DRP	2.5m	Loan from A Co	0.5m
Other business property	4m	Equity	
		Shareholder capital	6m
Total	**6.5m**	**Total**	**6.5m**

Since Holding Co, A Co and B Co are members of a wholly-owned group, it is not necessary to determine whether they are residential land companies. Instead, the formula in section DH 5(10) is applied to the Land Group:

- The value of disqualified property is: $2m (in A Co) + $2.5m (in B Co) = $4.5m.
- The value of indirect disqualified property is zero. (The shares held by Holding Co are intra-group shares and therefore disregarded on a consolidated basis.)
- The value of total assets (excluding intra-group assets) is: $3.5m (in A Co) + $6.5m (in B Co) = $10m.

The value of Land Group's disqualified property and indirect disqualified property as a percentage of its total assets is 45% ($4.5m/$10m). Therefore, Land Group is not a residential land wholly-owned group.

Consequently, Holding Co, A Co and B Co are not residential land wholly-owned group members and do not have to apply subpart DH. This is notwithstanding that if the formula for an individual residential land company in section DH 5(8) were applied to A Co, A Co would be a residential land company.

Close companies

Section DH 3(a) provides that the interest limitation rules apply to a close company that is not an exempt Māori company.

Meaning of close company

A close company is a company that is controlled by a small number of individuals.

The term "close company" is defined in section YA 1. In general terms, a company is a close company if at any time there are five or fewer natural persons or trustees the total of whose voting interests in the company is more than 50 percent. For the purposes of this definition, natural persons that are associated with each other are treated as a single person.

Exempt Māori company

The term "exempt Māori company" is defined in section DH 5(4).

An exempt Māori company is a company that is:

- a Māori authority or eligible to be a Māori authority, or

- wholly-owned by a Māori authority or by a company or trust that is eligible to be a Māori authority, and
- not a "residential land company" (if it is not a member of a wholly-owned group) or a "residential land wholly-owned group member" (if it is a member of a wholly-owned group).

A Māori authority is a trustee, or a certain type of company, with the obligation to administer assets communally owned by Māori that has elected, under section HF 11, to become a Māori authority. Section HF 2 specifies the persons eligible to be a Māori authority.

The exclusion for an "exempt Māori company" recognises that, while an exempt Māori company may legally be a close company, it is, in substance, a company for the benefit of, and accountable to, a very large number of individuals. In terms of control and governance, an exempt Māori company is very different to a typical close company.

To be an exempt Māori company, a company cannot be a "residential land wholly-owned group member" if it is a member of a wholly-owned group, or a "residential land company" if it is not a member of a wholly-owned group. These terms are explained above. This ensures that Māori companies whose main business involves DRP (other than DRP subject to the land business or development exemptions) still have to apply the interest limitation rules.

Excepted residential land – schedule 15

Sections DH 5(3) and YA 1 and schedule 15 of the Income Tax Act 2007

Excepted residential land is excluded from the interest limitation rules. Schedule 15 sets out the types of land that are considered "excepted residential land."

Background

The interest limitation rules apply to disallowed residential property (DRP). Commercial properties that are not set up to provide accommodation (for example, office buildings and shops) are not intended to be covered by subpart DH.

However, some commercial properties are used to provide accommodation. Commercial accommodation can take a variety of forms. In some cases, the provision of accommodation is related, but ancillary, to another function of the property (for example, a hospital or hospice). In most cases, it is not intended that these types of property be subject to interest limitation under subpart DH. This is because, while stays in such properties could be long term, they are generally not substitutable for an owner-occupied property. In other cases, the provision of accommodation is the core function of the property or business. Properties used to provide accommodation on a commercial basis can take a variety of forms. Some of these cannot easily be made suitable for owner-occupation (for example, a hotel or motel) and are thus more suitable for an exclusion, while others could more easily be used or converted to this purpose (for example, short-stay accommodation in what could otherwise be a regular residential home) and should be subject to interest limitation to ensure there is no negative impact on housing supply.

Some property types are not necessarily commercial in nature, but they do not impact on the general New Zealand housing market and are therefore excluded from the rules. These include properties located outside New Zealand.

Key features

New section DH 5(3) and schedule 15 provide that the following types of land are "excepted residential land":

- Business premises (this does not cover business premises that are used or available for use in a business of supplying accommodation).
- Farmland.
- A hospital, convalescent home, nursing home, or hospice.
- A hotel, motel, inn, hostel, or camping ground.
- A boarding establishment.
- A rest home or retirement village.
- The person's main home.
- Student accommodation.
- Employee accommodation.
- Māori excepted land.

Application date

The new provisions came into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Detailed analysis

Section DH 5(2)(b) provides that land is not included in DRP for the interest limitation rules to the extent to which it is "excepted residential land". Section DH 5(3) defines "excepted residential land" as land to the extent to which it is described in schedule 15.

The schedule lists the different types of land and property that are excepted from the interest limitation rules. Note that they are excepted *to the extent that* they are described in the schedule. Where some areas of a given parcel of land or property meet the criteria and others do not, a reasonable apportionment must be made on normal tax apportionment principles.[6]

Main home (clauses 1 and 7)

Clauses 1 and 7 of the schedule provide that a person's main home is excepted from the interest limitation rules. This relies on the pre-existing definition of "main home" in section YA 1 – the one place that is used as a residence by the person or, if they have more than one residence, the residence with which they have the greatest connection.

Clause 7 permits interest deductions to continue to be taken where a homeowner rents out a room (or rooms) in their main home to flatmates, private boarders, or as short-stay accommodation. It also applies to a non-accommodation income-earning use of the main home – for example, a workshop or a contractor's home office.

Clause 1 mirrors the business premises exclusion in the bright-line test, which provides that the business premises exclusion applies for premises used for an accommodation business only if it is the person's main home. This is intended to capture, for example, a bed and breakfast establishment where the owner lives onsite.

Example 7: Main home

Tane owns two residential properties – one in Wellington and another up the coast at Waikanae beach. He has mortgages over both properties. He spends most of his time in Wellington. Tane has a flatmate at his Wellington property.

Tane spends many weekends at his property in Waikanae, normally driving up Friday night and returning to Wellington on Sunday.

[6] For more on this interaction, see the "Definition of disallowed residential property" section of this special report.

Tane's Wellington property is his main home and is not subject to interest limitation under subpart DH. However, the proportion of interest expense on his mortgage he can deduct in relation to the rent from his flatmate is limited under other parts of the Income Tax Act 2007.

Tane's Waikanae property is a DRP. Interest expense on his mortgage on that property is subject to the interest limitation rules.

An exception from the interest limitation rules in subpart DH does not mean that interest deductions are automatically available for the main home. Other requirements in the Income Tax Act 2007 still need to be satisfied, including meeting the general permission (that is, a nexus to income exists) and not being subject to the general limitations. For example, to the extent an expense relates to private use, deductions are generally not available. In a flatmate situation, this means apportioning expenses between shared areas, areas exclusively used by the flatmate, and areas exclusively used by the homeowner to determine the amount that is deductible.

Example 7 continued: Apportioning interest for the main home exception

Consider Tane's main home in Wellington and the income he derives from having a flatmate. Tane's monthly interest expense on his mortgage is $600.

Tane has exclusive use of one bedroom, an ensuite and a spare room, which he uses as an office. His flatmate has exclusive use of a second bedroom and a different bathroom. They both have shared use of the lounge, dining room, kitchen and laundry. Looking at the shared-use and exclusive-use areas, Tane calculates that 30% of his interest expense relates to the income from his flatmate and is deductible. The remaining 70% is non-deductible due to the private limitation. Tane calculates he can deduct $180 of his monthly interest expense.

To qualify for the main home exception, the person who incurs the interest and the person who owns the main home would generally need to be the same person. In most cases, only natural persons can be considered to have main homes. However, an individual who holds their property through a transparent entity, like a look-through company (LTC), may be able to qualify for the main home exception. This is because shareholders in LTCs are deemed to hold their proportion of LTC assets directly for tax purposes. Opaque structures, such as ordinary (non-LTC) companies, do not have access to the main home exception.

Trusts are generally opaque, but it is not uncommon for people to hold their homes in trust structures. Therefore, clauses 1 and 7 contain an additional rule for trusts. This rule provides that a property can be excepted residential land under the main home exception for the trustee of a trust if it is the main home of one of the trust's beneficiaries and a principal settlor does not have a different main home of their own. A principal settlor is someone whose settlements for the trust are the greatest, or greatest equal, by market value. This ensures that trusts cannot be used to gain an exception from the interest limitation rules if such an exception would not be available if the settlors held the property directly.

Example 8: Main home exception, settlors and beneficiaries

Michael and Stephen have bought a house in Auckland for their son, Jeremy, to live in. They settle the house in a family trust of which they are the trustees and principal settlors. They, along with Jeremy, are the beneficiaries.

Jeremy finds flatmates who pay market rent for the spare bedrooms.

Initially, Michael and Stephen continue to live in their own main home in Hamilton. This means they cannot claim the main home exception for the Auckland house because, as principal settlors, they have a different main home. The trustees would only be able to claim the exception if Michael and Stephen had no main home or lived in the Auckland property.

Years later, Michael and Stephen retire. They decide to move into the Auckland property because Jeremy has moved elsewhere. The spare bedrooms are rented out for short-stay accommodation on a digital platform. From this point on, the trustees qualify for the main home exception in clause 7 of schedule 15 for the Auckland property. This is because Michael and Stephen, as principal settlors of the trust, do not have a different main home.

Where there are multiple residential properties on the same parcel of land (for example, a self-contained flat or cottage, sometimes advertised as "home and income"), only the property used by the owner as the main home qualifies for the main home exception. Thus, the carve-out from DRP only applies to the part that is the main home. Other self-contained units on the same title are DRP and subject to interest limitation under new subpart DH. This is the same result as if the multiple units or properties were on separate legal titles.

Example 9: Multiple residences on a single legal title

Mandi owns a property that was advertised as "home and income". The building is split into two – a self-contained one-bedroom flat on the ground floor and a larger three-bedroom unit above it.

Mandi lives in the upstairs three-bedroom unit. Mandi wants a flatmate in her unit and also wants to find a tenant for the downstairs flat. Mandi's friend Miriama moves in to one of the bedrooms upstairs. Mandi advertises the downstairs flat online and finds a tenant to move into it.

The upstairs three-bedroom unit is Mandi's main home and qualifies for the main home exception. Mandi would be able to deduct some of the interest expense on her mortgage against her rental income from Miriama. The downstairs one-bedroom flat is not part of her main home and would be DRP subject to the interest limitation rules.

Business premises (clause 1)

Clause 1 of schedule 15 contains an exception for business premises.

Section YA 1 provides that "business premises" is defined in section DD 11 for the entertainment expenditure and land sales provisions as follows:

> **business premises**—
>
> (a) means the normal business premises or a temporary workplace of the person (or an associate):
>
> (b) does not include premises or a workplace established mainly for the purpose of enjoying entertainment.

This definition is intended to apply for the purposes of the interest limitation rules.

The business premises exception is intended to buttress the general rule in section DH 5(2)(a), which provides that land is DRP to the extent it has a place configured as a residence or abode. Under that general rule, if the parcel of land does not contain such a structure, it is not DRP.

The interest limitation rules should not apply to property used for commercial purposes unrelated to accommodation (for example, shops, offices, entertainment venues, warehouses, factories) as these kinds of property are not generally configured as residences and are therefore unlikely to meet the basic definition of DRP. However, the business premises exception is intended to put any ambiguity beyond doubt.

In some cases, the property may originally have been configured a residence or abode, but it has since been reconfigured for a different purpose or used for a non-accommodation business. For example, consider a villa that has been converted into a doctor's surgery or a restaurant. If there is any ambiguity in determining whether this villa is DRP under section DH 5(2)(a) and subject to interest limitation, the business premises exception in clause 1 of schedule 15 applies to ensure that the villa is not subject to interest limitation.

Premises used for a business of supplying accommodation do not qualify for the business premises exception in clause 1 unless it is the owner's main home (as discussed under the heading "*Main home (clauses 1 and 7)*" above) or is covered by another specific exception in schedule 15.

This ensures that short-stay accommodation in a standard residential property is subject to the interest limitation rules in the same way long-term rental property is. An exclusion for such accommodation could have a detrimental impact on the supply of available housing in New Zealand for renters and owner-occupiers.

An exception to this rule exists where the premises used for a business of supplying accommodation are the person's main home. This exception is intended to cover bed and breakfast establishments where the owner lives onsite and is discussed under the heading "*Main home (clauses 1 and 7)*" above.

Businesses providing accommodation on a commercial scale, such as hotels and motels, are carved out in specific exceptions elsewhere in schedule 15, discussed below.

Farmland (clause 2)

Farmland is excepted from the interest limitation rules under clause 2 of schedule 15. "Farmland" is defined in section YA 1 as land that is being worked in the farming or agricultural business of the land's owner or that, because of its area and nature, is capable of being worked as a farming or agricultural business. A farming or agricultural business includes forestry, horticultural and pastoral businesses.[7]

[7] For further discussion on the meaning of "farmland" and how this differs from a lifestyle block, see QB 18/17 'Income tax – bright-line test – farmland and main home exclusion – sale of lifestyle blocks' available at https://www.taxtechnical.ird.govt.nz/en/questions-we-ve-been-asked/2018/qb1817-qb-1817-income-tax-bright-line-test-farmland-and-main-home-exclusions-sale-of-lifestyle-block

To be "capable of being worked as a farming or agricultural business", the parcel of land must be capable of producing revenue sufficient to cover all costs of holding and operating the land over time without significant investment or modification. This includes the cost of capital employed and a reasonable recompense for the proprietor's labour.

However, given that the interest limitation rules apply to land to the extent the land contains a place configured as a residence or abode, the exception for farmland in schedule 15 also specifically includes such structures. Thus, any place configured as a residence or abode, whether used as such or not, and including any appurtenances belonging to or enjoyed with the place, is included in the farmland exception. This ensures that a farmhouse or workers' quarters on the farmland is not subject to interest limitation.

Accommodation in medical and care facilities (clause 3)

Accommodation provided in hospitals, convalescent homes, nursing homes, and hospices is excepted from the interest limitation rules. These forms of accommodation are specifically intended for patients and those in need of care and are generally straightforward to distinguish from standard residential properties.

These terms are not defined in the Income Tax Act 2007. Therefore, whether a given property qualifies for an exception under clause 3 depends on the particular facts and circumstances.

Excepted commercial accommodation (clauses 4 and 5)

Clauses 4 and 5 provide an exception for various forms of commercial accommodation. These forms of accommodation are designed predominantly for short-term use on a large-scale commercial basis. They are generally straightforward to distinguish from standard residential properties that could be a private owner-occupied residence. Exceptions for these listed types of accommodation do not disadvantage prospective owner-occupiers or generally impact the housing market.

Boarding establishments (clause 4)

The commercial accommodation exceptions broadly mirror those in paragraph (b)(ii) of the previous definition of "dwelling" in section YA 1 of the Income Tax Act 2007. However, no exception for a "boardinghouse" is provided. Instead, clause 4 provides an exception for a new defined term, a "boarding establishment".

Note that the definition of "dwelling" in section YA 1 has also been amended to replace the term "boardinghouse" with "boarding establishment" for the 2022–23 and later income years. See the "Amendment to definition of 'dwelling'" section of this special report for more information.

Having a new defined term that is not "boardinghouse" is intended to provide clarity to taxpayers and reduce any uncertainty or confusion created because of the similar term "boarding house" in the Residential Tenancies Act 1986 (the RTA).

An exception for an RTA "boarding house" was not considered to be appropriate because, for many properties, it is simply the difference between renting a house out on a single contract versus renting a house out on a room-by-room basis.

Conversely, a "boardinghouse" is undefined for tax purposes, and whether a property constitutes a "boardinghouse" depends on the facts and circumstances of each property so that the answer may not always be clear to landlords applying the interest limitation rules.

Larger boardinghouses may be structurally similar to hostels and may not be suitable for owner-occupation, but smaller boardinghouses may resemble standard residential properties and should prima facie be subject to interest limitation.

To ensure that large-scale commercial boardinghouses are not subject to interest limitation, the defined term, "boarding establishment", has been introduced into section YA 1. This term is intended to encompass commercial boardinghouses unsuitable for owner-occupation.

A "boarding establishment" is defined as premises that:

- are used in a business of supplying accommodation
- are managed by the business
- consist of at least ten boarding rooms that are not self-contained (that is, they do not contain all the necessary features for living, such as a full kitchen or bathroom), and
- include shared living facilities (which provide the necessary features for living not delivered in the residents' boarding rooms) available to all residents.

All these requirements must be satisfied for premises to qualify for the "boarding establishment" exception.

Example 10: Property rented out on a room-by-room basis

Gordon owns a six-bedroom villa in central Auckland that he previously rented out on a single tenancy contract. Gordon decides it is better for him and more convenient for the tenants to rent the house on a room-by-room basis.

Each occupant signs a contract for exclusive use of their individual room and shared use of common areas, like the lounge, kitchen and two bathrooms. Under the Residential Tenancies Act 1986, the bedrooms are boarding rooms, and the house is a boarding house.

Gordon's property is not a boarding establishment and therefore does not qualify for the boarding establishment exception in clause 4 of schedule 15. Because the property has fewer than ten boarding rooms that are not self-contained, there is no need to consider whether it satisfies the other limbs of the definition.

Management by the business is intended to encompass a range of scenarios, including, for example, where a manager lives on-site and has a permanent office, or where someone travels between multiple establishments operated by the business across different locations in a city.

Premises refers to a single site or location, although the relevant facilities may be in multiple buildings on the same site. Buildings located on different pieces of land do not satisfy the requirements, even if the sections are adjacent.

A taxpayer might operate several establishments at different locations. Each location needs to satisfy the "boarding establishment" requirements to be considered excepted residential land. This means that a taxpayer could have multiple boarding establishments for the purposes of subpart DH.

Provided the establishment contains at least ten boarding rooms that are not self-contained, other boarding or cabin-style rooms on the same site would form part of the "boarding establishment" and qualify for the exception.

Example 11: Boarding establishment

Carl and Emily own C&E Boarding Lodge, a commercial establishment in New Plymouth. C&E Boarding Lodge consists of:

- 12 rooms that are not self-contained, with no additional private facilities
- a further six rooms with individual ensuites, and
- six pre-fab cabins with basic bathroom and kitchen facilities.

Occupants sign the same contract, regardless of the type of room, and all occupants have access to shared living facilities, including communal lounges, a commercial-sized kitchen, bathrooms and a coin-operated laundry. Electricity and gas are included in the weekly rent.

Occupants are expected be neat and tidy, although C&E Boarding Lodge cleans and maintains the communal areas and ensures that furnishings in the boarding rooms are in reasonable working order.

C&E Boarding Lodge qualifies as a "boarding establishment", because there are more than ten boarding rooms that are not self-contained.

However, the premises must still have at least ten boarding rooms that are not self-contained. If there are fewer than ten rooms that are not self-contained, the balance required cannot be satisfied by other rooms.

Example 12: Fewer than ten boarding rooms that are not self-contained

Ivy owns "City View Lodge" in Auckland, which consists of a large house and some self-contained studio units at the back of the section. There are:

- six boarding rooms that are not self-contained, with no additional private facilities, and
- four self-contained studio units with basic bathroom and kitchen facilities.

Occupants sign the same contract, regardless of the type of room, and all occupants have access to shared living facilities in the main house, including a communal lounge, a kitchen, bathrooms and a laundry. Electricity and gas are included in the weekly rent.

City View Lodge does not qualify as a "boarding establishment", because even though it has a total of ten rooms for accommodation, only six satisfy the requirement that they are not self-contained.

Other commercial accommodation (clause 5)

Hotels, motels, hostels, inns, and camping grounds are excepted from the interest limitation rules under clause 5. These terms are not defined in the Income Tax Act 2007. Therefore, whether a given property qualifies for an exception under clause 5 depends on the facts and circumstances of each property.

Rest homes and retirement villages (clause 6)

Rest homes and retirement villages are excepted from the interest limitation rules. Retirement villages are defined in the Retirement Villages Act 2003 as, broadly, premises containing two or more residential units that provide, or are intended to provide, residential accommodation together with services or facilities, or both, predominantly for persons in their retirement.[8] The Health and Disability Services (Safety) Act 2001 considers rest home care to be services provided on premises held out as being principally "a residence for people who are frail because of their age".[9] Both retirement villages and rest homes are subject to regulatory frameworks set out in the above Acts.

Student accommodation (clause 8)

Certain student accommodation is excepted from the interest limitation rules. A new definition of "student accommodation" that applies for the purposes of subpart DH has been inserted in section YA 1 of the Income Tax Act 2007. The definition is intended to align with the pre-existing regulatory regime in section 5(1)(h) of the Residential Tenancies Act 1986 (RTA), and it defines "student accommodation" as follows:

- means commercial boarding premises used to provide accommodation for students enrolled at a registered school or premises described in section 5B of the RTA, and
- includes premises described in section 5B of the RTA even if they are used mainly, but not exclusively, for the accommodation of students.

Broadly, section 5B of the RTA covers exempt student accommodation and describes premises owned or operated by, or in conjunction with, a tertiary education provider and used to provide accommodation for students. A "tertiary education provider" is defined in section 10(1) of the Education and Training Act 2020 and includes universities, wānanga, Te Pūkenga—New Zealand Institute of Skills and Technology, private training establishments and government training establishments.

This exception is available for halls of residence and hostels that are owned by either the tertiary education provider, or another person who has a specific arrangement with the tertiary education provider, and that meet the requirements under the RTA.

[8] See section 6 of the Retirement Villages Act 2003 https://www.legislation.govt.nz/act/public/2003/0112/latest/contents.html
[9] See section 6 of the Health and Disability Services (Safety) Act 2001 https://www.legislation.govt.nz/act/public/2001/0093/latest/contents.html

This exception is not available to a landlord who leases their residential rental property to students privately.

Example 13: Accommodation rented to students that does not meet criteria

Ralph owns a five-bedroom house in Kelburn, close to Victoria University of Wellington. Because of its proximity to the university, Ralph rents the rooms in the property exclusively to students on an individual basis. Ralph decided that this approach was more convenient and more appropriate for his investment strategy than renting out the house on a single lease.

Although the property is accommodation provided exclusively to students, Ralph has no arrangement with the university as set out in section 5B(5) of the Residential Tenancies Act 1986. Likewise, he does not provide any services for his student tenants over and above the minimum required under Part 2 of the Residential Tenancies Act 1986 (as required by section 5B(2)). The property is not excepted residential land and would therefore be DRP and subject to the interest limitation rules.

Section 5B of the RTA requires that the property must be exclusively used to provide accommodation to students. However, paragraph (b) of the definition of "student accommodation" in section YA 1 provides that exclusive use as student accommodation over the course of the year is not required for the exception to be available. This is intended to allow the exception for student accommodation to continue to apply for the year where, for example, apartments in a hall of residence are rented out over the summer break to non-students.

Example 14: Student accommodation used for other purposes over summer break

StudyLyfe is a privately owned company and is a hall of residence owner. It operates a single building with 100 apartments. It has an agreement with Victoria University of Wellington that satisfies the requirements of section 5B of the Residential Tenancies Act 1986.

During semesters one and two, all 100 apartments are rented exclusively to students. However, over the summer, the reduced demand for tuition means the demand for student accommodation is also reduced. StudyLyfe continues to rent out 20 apartments to summer students but puts the other 80 on the general rental market on short-term leases.

Although the hall is not exclusively used for student accommodation over the summer, paragraph (b) of the definition of "student accommodation" means the building qualifies as excepted residential land for the whole year. No apportionment is required to reflect the change of use in the summer period. Interest incurred for StudyLyfe's building is not subject to the interest limitation rules in subpart DH.

Employee accommodation (clause 9)

Employee accommodation is excepted residential land and excluded from the interest limitation rules. A new definition of "employee accommodation" has been inserted in section YA 1 of the Income Tax Act 2007. The definition provides that "employee accommodation" means property provided by a person, or a company in the same wholly-owned group as the person, to their employees or other workers for accommodation in connection with their employment or service. The inclusion of property provided to a person's employees by a company in the same wholly-owned group as the person takes into account corporate group scenarios where the company employing the workers may not be the same company that holds the property. However, the definition does not include accommodation provided to employees or other workers who are associated with the person, unless it is necessary for the person to provide the accommodation because of the nature or remoteness of their business.

The definition follows the existing exclusion for employee accommodation in the residential rental loss ring-fencing rules contained in subpart EL of the Income Tax Act 2007.

Māori excepted land (clause 10)

Clause 10 of schedule 15 provides that "Māori excepted land" is excepted residential land and therefore not subject to interest limitation. "Māori excepted land" is defined in section YA 1 as follows:

- Māori customary land, Māori freehold land, Crown land reserved for Māori, and land set aside as a Māori reservation (paragraph (a)(i)).
- Land provided as a residence to a shareholder or beneficiary of a Māori authority (including an entity eligible to be a Māori authority) to the extent the land is partly or wholly owned (directly or indirectly) by that Māori authority or entity. This extends to situations where multiple Māori authorities or entities co-own land, such as through a limited partnership, and use it to provide residences for their members. This is intended to cover Māori communal housing, such as papakāinga and kaumātua

housing, where such housing is on general title land and not otherwise covered by paragraph (a)(i) above (paragraph (a)(ii)).

- Land owned, directly or indirectly, by a Māori authority (or entity eligible to be one) to the extent the land was acquired under a Treaty settlement or a post-Treaty settlement mechanism (for example, through a right of first refusal) relating to that Māori authority (or eligible entity). This includes land that is subsequently transferred by the post-settlement governance entity to members of the claimant group or within an entity's corporate structure (paragraph (a)(iii)).
- However, where land described in paragraph (a)(iii) is held by a Māori authority (or entity eligible to be one) and leased to a third party that is not owned, directly or indirectly, by that Māori authority or eligible entity, the lessee is not able to claim the exception. In this case, only the lessor qualifies for the exception from interest limitation (paragraph (b)).

The purpose of paragraphs (a)(i) and (a)(ii) is to provide an exception for papakāinga or kaumātua housing that would otherwise be subject to the interest limitation rules because the resident pays rent. The aims of papakāinga housing include providing whānau with quality affordable housing and promoting Māori community development. Papakāinga housing therefore plays an important role in supporting and fostering cultural identity and financial stability. Kaumātua housing can play a similar role, while also recognising the important role that elders have in society. The interest limitation rules should not hamper these aims.

The purpose of paragraphs (a)(iii) and (b) is to ensure the interest limitation rules do not impact on Māori communities' ability to retain and make unencumbered use of land returned to them via Treaty settlement. This is intended to recognise the role of Treaty settlements in acknowledging, and providing redress for, the Crown's breaches of te Tiriti o Waitangi and how this cultural context can impact how land returned under a Treaty settlement is subsequently held.

Paragraph (a)(i)

The terms used in paragraph (a)(i) are defined in Te Ture Whenua Māori Act 1993. The legal framework in Te Ture Whenua Māori Act 1993 governs the use of Māori land and how such land can be bought and sold.

In many cases, land included in paragraph (a)(i) does not satisfy the general definition of DRP to begin with. In this situation, the exception puts beyond doubt that the rules in subpart DH do not apply.

In other cases, where there is residential property on the land (for example, in the form of papakāinga or kaumātua housing), the ability to reside in the property is generally only available through an occupation order or a licence to occupy and may be limited to those having a connection to the hapū or whānau who hold the land. It is uncommon that land such as that described in paragraph (a)(i) can be sold, or rented, to a member of the general public.

Paragraph (a)(ii)

Not all papakāinga and kaumātua housing is on Māori title land and covered by the exception in paragraph (a)(i). Paragraph (a)(ii) is intended to provide an exception where papakāinga and kaumātua housing is located on general title land.

Properties on general title land used to provide long-term rental accommodation should, in most cases, be subject to interest limitation. This should include where a Māori authority holds a residential property on general title land that it rents out on arm's length terms to a member of the general public

The exception in paragraph (a)(ii) only applies where housing on land owned by a Māori authority, an entity eligible to be a Māori authority, or an entity that is wholly owned or controlled (either directly or indirectly) by a Māori authority or eligible entity, is provided to a shareholder or beneficiary of that Māori authority or eligible entity.[10]

The reference to a shareholder or beneficiary of a Māori authority or eligible entity is intended to ensure the exception is only available to housing provided to members of the iwi, hapū or whānau represented by the Māori authority or eligible entity.

The reference to indirect ownership is intended to cover ownership structures where there is a nested structure and the land is not held by the top-level entity. This covers a chain of wholly-owned subsidiary companies. It is also intended to cover a trust that is controlled by an entity in the chain where beneficiaries of that trust may either be the same individuals who are shareholders or beneficiaries of the top level entity, or another entity in the chain.

The entity that actually manages the housing does not need to be the one that owns the land. This mirrors how the social housing exemption in new section DH 4(4) operates.[11]

In some situations, the Māori authority set up to hold the land is not the entity that develops the property or manages the papakāinga or kaumātua housing. This could be for a variety of

[10] Māori authorities can be trusts or companies.
[11] For more on the social housing exemption, see the "Social, emergency, transitional, and council housing" section of this special report.

reasons including, for example, being due to the original mandate of the land-owning Māori authority. The land-owning entity may contract out to a subsidiary or another party to manage the provision of housing. In such a case, the exception in paragraph (a)(ii) would still be available.

Example 15: Māori housing on general title managed by entity not a Māori authority

An iwi acquires a large block of land on general title close to its marae. It decides to invest in a papakāinga housing development on this land to encourage community development around the marae.

The land is held by a trust, MA Trust, that is eligible to be a Māori authority. The trust benefits the iwi and its members. MATrust has a loan that was drawn down to acquire the land.

MATrust enters into an arrangement with a related entity, PPKCo, for the construction and management of the housing.

PPKCo engages a private developer, DevCo, to construct the papakāinga housing.

PPKCo takes out a loan to fund the construction of the papakāinga housing. It builds the houses and rents them to members of the iwi at affordable rates. Once constructed, PPKCo owns the housing on the land. While PPKCo manages the properties on a day-to-day basis, the land remains owned by MATrust.

As the housing is on land owned by an entity eligible to be a Māori authority (MATrust) and provided as a residence to the beneficiaries of that entity (the iwi members who benefit from MATrust), the housing would be covered by the exception in paragraph (a)(ii). This is the case even though the housing is provided by a different entity, PPKCo.

The exception in paragraph (a)(ii) would apply for both MATrust and PPKCo.

Collective housing projects

In some cases, general title land used for papakāinga and kaumātua housing is not held by a single Māori authority, but rather by multiple Māori authorities using a structure allowing for joint ownership, such as a limited partnership. The partnership develops homes on the land for rent by members of the relevant iwi represented by the partners. Some of the houses may be rented to the general public.

It is intended that a limited partnership housing project representing multiple iwi and hapū qualifies as Māori excepted land to the extent it is provided as a residence to beneficiaries or shareholders of one or more of the Māori authorities involved in the limited partnership.

To be eligible for the exception, the partner/co-owner must be:

- a Māori authority or entity eligible to be one, or
- an entity owned (directly or indirectly) by a Māori authority or eligible entity.

Partners in a collective housing project who are neither a Māori authority (or eligible to become one) nor owned directly or indirectly by such an entity do not qualify for the exception. This could include a private developer or investor involved in the project, for example.

Example 16: Limited partnership in a collective housing project

Three iwi, Iwi A, Iwi B, and Iwi C, form a limited partnership to hold 20 houses on a large block of land on general title as papakāinga housing. Iwi A's share in the partnership is 40%, while Iwi B and Iwi C each have a 30% share. The agreement is to develop 20 houses to be rented to members of the three iwi, based on each iwi's share in the partnership.

Iwi A and Iwi B hold their shares in the partnership via landholding trusts that are eligible to be a Māori authority and can therefore claim their share of interest deductions under paragraph (a)(ii). Iwi C is a Māori authority, but it holds its share in the partnership through a company wholly owned by Iwi C, LandCo, which is not itself eligible to be a Māori authority. However, as LandCo is 100% owned by a Māori authority, it is able to claim its share of interest deductions under paragraph (a)(ii).

The limited partnership's interest expense for the year for the 20 houses is $200,000. The partners allocate the interest among themselves according to their share in the partnership. Since all of the 20 houses in the development are rented exclusively to members of Iwi A, Iwi B, and Iwi C, all of the interest is incurred for Māori excepted land and is therefore not subject to denial of deductions under subpart DH. Iwi A can claim 40% of the interest (or $80,000), while Iwi B and Iwi C can claim 30% (or $60,000) each.

In some situations, some houses on the land might be rented to the general public, rather than being reserved for members of the Māori authorities involved in the partnership. Land is not considered to be Māori excepted land where it is provided as a residence to people other than beneficiaries or shareholders of the relevant Māori authorities.

In this case, standard tax apportionment principles need to be applied to determine the proportion of housing provided to the partners' members versus non-members at the partnership level. This percentage is then applied by each eligible partner to determine what proportion of their allocated interest expense can be deducted.

Example 16 continued: Houses in a collective housing project rented to general public

To help raise funds for the purchase, the three iwi agree to bring a fourth investor into the limited partnership. The fourth investor, D Co, is a private investor and is not a Māori authority, an entity eligible to be one, or directly or indirectly owned by one.

Each iwi trades a 5% share of the partnership to D Co and, as part of the amended partnership agreement, three of the 20 houses are rented to the general public. The three houses do not qualify as Māori excepted land under paragraph (a)(ii) and are disallowed residential property. The overall position of each partner is shown in the table below:

	Iwi A	Iwi B	Iwi C	D Co	Total
Share of partnership	35%	25%	25%	15%	100%
Number of houses	7	5	5	3	20

The limited partnership's interest expense for the year for the housing project is $200,000. To work out how much interest expense each partner can deduct and how much is ineligible, the partnership must first determine the proportion of the property that qualifies as Māori excepted land at the partnership level — 17 of the 20 houses, or 85%. Each eligible partner will then apply this percentage to their allocated interest expense.

The interest is then allocated to each partner according to their share of the partnership, as shown in the table below:

	Iwi A	Iwi B	Iwi C	D Co
Share of partnership	35%	25%	25%	15%
Allocated share of partnership interest	$70,000	$50,000	$50,000	$30,000
Eligible interest in relation to Māori excepted land	$59,500	$42,500	$42,500	$0
Interest denied	$10,500	$7,500	$7,500	$30,000

Iwi A claims an interest deduction of $59,500 (85% x $70,000), while Iwi B and Iwi C claim a deduction of $42,500 each (85% x $50,000). The ineligible interest allocated to each iwi in relation to disallowed residential property (being 15%) is denied under subpart DH.

While D Co, prima facie, may have eligible interest of $25,500 (being 85% of $30,000), D Co is not a Māori authority or entity eligible to be one, and is not owned by such an entity. D Co is denied any deduction in relation to its share of the partnership interest, even for its share of property that would otherwise be Māori excepted land.

Paragraphs (a)(iii) and (b)

An exception is also considered to be appropriate in the context of land acquired under a Treaty settlement, given the role of Treaty settlements in acknowledging and addressing breaches by the Crown under Te Tiriti o Waitangi – The Treaty of Waitangi. It would not be appropriate for interest limitation to impact the value of Treaty settlements or the economic viability of Treaty settlement land. It could also create fairness issues between iwi groups that have already settled and those that have not.

Therefore, paragraph (a)(iii) provides that land held directly or indirectly by a Māori authority, or an entity eligible to be one, where the land was acquired as part of a Treaty settlement (including post-Treaty settlement mechanisms such as a right of first refusal), is Māori excepted land and is not subject to the interest limitation rules. The reference to indirect ownership ensures that the exception continues to apply if the land is transferred within a wholly-owned group of companies and corporate group structures involving a trust. If the land is on-sold (for example, to a property investor beyond the claimant group), the exception would not apply to that subsequent owner.

Note that, for tax purposes, land includes an "interest in land", which can include a ground lease from the perspective of the lessee. Many apartment buildings, particularly in Auckland city, are on ground lease land – this means that an investor in such an apartment would have a leasehold interest, rather than a freehold interest. That is, they would own the physical apartment but not the underlying land.

It is not uncommon for Treaty settlement land to be the subject of a long-term ground lease (for example, on a 99-year term). This allows the land to be developed and used efficiently by a third party while ensuring continuing ownership of the land itself.

Paragraph (b) ensures that the exception in paragraph (a)(iii) for Treaty settlement land does not apply to these leasehold interests by limiting the application of paragraph (a)(iii) to only the underlying owner of the land. This is to ensure that, for an investor purchasing a leasehold apartment, it should not matter to them who the ground lessor is or whether the land was returned under a Treaty settlement.

Therefore, paragraph (b) is necessary to ensure that property investors with leasehold interests in Treaty settlement land are not excluded from the interest limitation rules.

In some situations, the Māori authority (or eligible entity) that holds the land may not be able to use that particular entity to undertake development activity or manage the use of the land. Instead, they may set up another entity to carry out these activities and, to permit full use of the land, a ground lease may be entered into with that other entity as the lessee. In this case, the restriction in paragraph (b) does not apply.

Example 17: Ground leases and Treaty settlement land exception

LeaseCo is a private company engaged in property investment. LeaseCo has a 150-year ground lease for a parcel of land from a Māori authority for the purpose of building rental properties. LeaseCo owns the rental properties and derives rental income from the tenants. The Māori authority retains underlying ownership of the land. The Māori authority acquired the parcel of land via a post-Treaty settlement mechanism that gave it a right of first refusal over the purchase of the land; however, the Māori authority took out a loan to purchase the land.

The Māori authority is not subject to the interest limitation rules for its loan for the land, as the land meets the requirements of the definition of "Māori excepted land" (paragraph (a)(iii)) and is therefore excluded from being disallowed residential property

(DRP). However, as LeaseCo is not owned by the Māori authority, the land is excluded from the definition of "Māori excepted land" for LeaseCo by paragraph (b). The land is therefore DRP and LeaseCo is subject to the interest limitation rules in subpart DH for the interest it incurs on the rental properties.

Exemptions for new housing supply – an overview

Sections DH 4(1)(2) and (3), DH 5(7), and YA 1 of the Income Tax Act 2007

The land business, development, and new build exemptions from the interest limitation rules all share the objective of ensuring the rules do not disincentivise investment in new housing supply. This section provides an overview of key concepts relevant to the exemptions and explains how the exemptions interrelate.

The land business, development, and new build exemptions

The **land business exemption** applies to interest incurred in relation to land held by taxpayers with professional property development, dealing, building or subdivision businesses under section CB 7. An exemption is provided for interest incurred in relation to land held in these businesses because they play an important role in the supply of new housing.

The **development exemption** applies to interest incurred in relation to land held by taxpayers who are undertaking activities on the land that contribute to new housing supply, but who are not professional property developers/builders so do not have a land business under section CB 7. Essentially, if a person does not qualify for the land business exemption but is developing land with an aim to creating new housing, then the development exemption should apply to the person.

The **new build exemption** generally applies once a new build has been added to the land, and in most cases applies for 20 years from the date the new build is completed. In most cases, the date a Code Compliance Certificate (CCC) was issued for a new build is used as a proxy for the date the new build was completed. The new build exemption will normally apply to interest incurred by a person who buys land with a new build on it (for example, from a property developer), or who has added a new build to land that they already own. All owners of new build land during the 20-year period qualify for the exemption – this includes the initial owner and any subsequent purchasers within that period.

The table on the following page compares how the three exemptions work at a high level.[12]

[12] See the "Land business exemption", "Development exemption", and "New build exemption" sections of this special report for more information on each of the exemptions.

Table 1: Comparing the land business, development, and new build exemptions

Exemption	What does it apply to?	Example	Start of the exemption	End of the exemption	Application to subsequent purchasers
Land business exemption	Interest incurred in relation to land held by a taxpayer in a section CB 7 land business (that is, a land building, development, subdivision, or dealing business).	*Interest incurred in relation to land held by a professional property developer.*	When land is acquired.	Ends when the taxpayer's section CB 7 land business ceases.	Does not transfer to subsequent purchasers. Subsequent purchasers can qualify if they themselves meet the criteria for the land business exemption.
Development exemption	Interest incurred in relation to land that the land business exemption does not apply to, but which is held by a taxpayer who has an undertaking or scheme to develop, build or subdivide land for the purpose of creating new build land.	*Interest incurred in relation to land being developed by a person who has a rental property business, but who is not a professional property developer themselves.*	When the person's undertaking or scheme begins.	Ends the earlier of when the land is disposed of or when it becomes new build land (in which case the new build exemption applies). Exceptions apply in rare cases.	Does not transfer to subsequent purchasers. Subsequent purchasers can qualify if they themselves meet the criteria for the development exemption.
New build exemption	Interest incurred in relation to new build land if it is incurred within 20 years of the new build being added to the land (usually the date the CCC for a new build on the land was issued).	*Interest incurred by a person who has bought land with a new build on it from a property developer and rents that new build out.*	When the land becomes new build land (normally when a new build's CCC is issued, unless the new build is purchased off the plans, when the exemption will apply from time of purchase).	Generally, for a taxpayer, ends the earlier of when the taxpayer disposes of the land, or when 20 years have passed from the date the new build's CCC was issued.	Transfers to subsequent purchasers within the 20-year period the exemption applies for.

Key concepts

Nexus required for interest to be deductible

The application of an exemption does not automatically guarantee that interest will be deductible. The exemptions stop the interest limitation rules from applying to the interest, either completely or for a period. However, normal tax rules regarding interest deductions still have to be satisfied for the interest to be deductible.

Flowchart 1: Nexus required to deduct interest

NOTE: THIS FLOWCHART PRESENTS A HIGH-LEVEL OVERVIEW OF KEY CONCEPTS AND MUST BE READ IN CONJUNCTION WITH THE EXPLANATORY TEXT IN THIS SPECIAL REPORT.

Is the general permission satisfied (that is, is there a nexus with income)? — **No** → ***Interest is not deductible***

Yes ↓

Do any of the general limitations apply? — **Yes** → ***Interest is not deductible***

No ↓

Does the land business exemption, development exemption, or new build exemption apply? — **No** → ***Interest limitation rules apply***

Yes ↓

Interest is deductible

This means that a taxpayer will need to consider whether they have satisfied the general permission in section DA 1 first, before they consider whether an exemption applies to them. The general permission allows a person a deduction for an amount of expenditure or loss to the extent to which it is incurred by them in deriving income or carrying on a business. That is, if a person's interest has a nexus (or a sufficient connection) with their income-earning activity, then the general permission enables them to deduct that interest unless a deduction is denied by another provision.

Once a person has determined they have satisfied the general permission, they will need to consider whether any of the general limitations in section DA 2 apply to prevent them deducting the interest. There are several general limitations, including the private limitation, which denies deductions for private or domestic expenditure or loss. There are also other specific provisions in the Income Tax Act 2007 that deny deductions that taxpayers will need to consider.

The below example illustrates how a nexus with income is required in the context of the new build exemption.

Example 18: No nexus because 'new build' is owner's main home

In 2022, Joshua buys a brand-new townhouse in New Plymouth that he decides to live in as his main home. He does not have any flatmates and does not use any part of the land as business premises. While the new build exemption would technically apply to any interest Joshua incurs in relation to the townhouse, he cannot deduct the interest because the interest has no nexus with income.

Fact variation: New build is used as rental property

Assume the same facts, but instead of living in the townhouse as his main home, Joshua rents it out. The new build exemption applies, and Joshua can deduct the interest he incurs in relation to the townhouse. There is a nexus between Joshua's income from the rental property and the interest he incurs on the townhouse, and there are no other provisions in the Income Tax Act 2007 that would prevent him from deducting the interest.

Example 19: Nexus and the development exemption

- Amal owns and manages multiple rental properties. Assume the activity amounts to a business. Amal has engaged a building firm to build a house on an empty piece of land. He intends to use this new build as another rental property in the future. In these circumstances, the development exemption would apply, and the interest incurred by Amal for the development activity would be deductible as there is a nexus with his larger property rental business.
- Annie engages a builder to build a property on an empty piece of land. Annie intends to live in the property with her wife as their main home and has obtained a loan to fund the development. Although Annie is building a new house, she has not met the requirements to obtain an interest deduction – there is no nexus to an income-earning activity.

What interest can qualify for the exemptions?

Any interest incurred in relation to land that qualifies for an exemption is deductible as long as the nexus with an income-earning activity is met.[13] This may include interest incurred on borrowings that relate to:

- acquiring land
- developing or subdividing the land
- constructing or installing a new build on the land
- land holding costs (such as rates and insurance)
- renovating, maintaining, or repairing a new build.

Example 20: Interest deductible under land business exemption

Kamal is a sole trader who carries on a successful business of building small houses and selling them to first home buyers. Kamal usually obtains a loan to buy the land and pay the related expenses of the building activity. This includes expenses such as the cost of buying the land, making any payments to local or building consent authorities in relation to the land, legal and other professional fees (such as for architects and surveyors) incurred in relation to the land, and the costs of building materials. Interest on the loan will be exempt from the interest limitation rules under the land business exemption and deductible because it meets the deductibility rules under existing tax law, being incurred in the course of carrying on a business to derive income.

Example 21: Exemption applies to all interest for new build land

Iona owns land that qualifies for the new build exemption. The new build on the land is always rented out. During the period the exemption applies, Iona decides to add a new deck to the new build. Iona will be able to deduct the interest she incurs on the loan she takes out to add the deck.

[13] And none of the general limitations or other provisions, apart from the interest limitation rules, would prevent the interest from being deducted.

Ten years after the new build receives its CCC, Iona decides to repaint it. She takes out another loan to pay for repainting the new build. The interest she incurs on that loan would also be deductible.

If Iona is still incurring interest in relation to the new build land after the exemption expires (20 years after the CCC was issued), she will not be able to deduct that interest because the interest limitation rule will apply.

What is "new build land"?

The development and new build exemptions both refer to "new build land". "New build land" is defined in section DH 5(7). Generally, new build land is defined to mean land that has a self-contained residence or abode on it, provided the residence/abode received a CCC on or after 27 March 2020 confirming it has been added to the land. Once such a residence or abode (a new build) has been added to residential land, that land becomes "new build land".

Land for which there is an agreement to add a new build may qualify as new build land. In addition, buildings that are converted into self-contained residences (such as office blocks converted into apartments, or large houses converted into multiple units), and existing buildings that are remediated for weathertightness or seismic issues, may also qualify as new build land if certain criteria are met.

For more information, see the "Definition of 'new build land'" section of this special report.

Apportionment may be required

The provisions that contain the exemptions (sections DH 4(1) to (3)) all include the words "to the extent", as shown in the table below.

New build exemption	Land business exemption	Development exemption
(1) This subpart[14] does not apply to interest incurred by a person **to the extent** to which it is– (a) incurred in relation to new build land; and (b) incurred before the date that is 20 years after the earliest of the following dates for the new build land …	(2) This subpart does not apply to interest incurred by a person **to the extent** to which it is in incurred in relation to a business described in section CB 7 (Disposal: land acquired for purposes of business relating to land).	(3) This subpart does not apply to interest incurred by a person (person A) **to the extent** to which it is incurred in relation to land (the land) that is or was subject to person A's undertaking or scheme involving development, division, or building for the purpose of creating new build land. However, the exemption in this subsection ceases for person A **to the extent** to which the land is new build land owned by person A.

The inclusion of the words "to the extent" means that sometimes interest will need to be apportioned because only a portion of the interest a taxpayer incurs qualifies for an exemption.

Apportionment will only be required where the interest incurred partially qualifies for an exemption. For example, where a loan is for a parcel of land that has both a new build on it and an older house that was built some time ago, only the interest that relates to the new build portion of the land would qualify for the new build exemption. Alternatively, there could be one loan that relates to two different parcels of land, one of which is new build land, while the other is subject to interest limitation. In this case, only interest incurred in relation to the parcel of land that is new build land would qualify for the new build exemption.

[14] The subpart referred to in these provisions is subpart DH, which contains the interest limitation rules.

Where apportionment is required, existing apportionment principles must be applied. Any reasonable apportionment method can be used – this can include a valuation-based apportionment method or a land area apportionment method.

Example 22: Interest relates to land with a new build and a non-new build

This example illustrates how interest could be reasonably apportioned where it only partially relates to new build land. There may be other apportionment methods that, if applied in accordance with existing tax principles, could also be considered acceptable.

Bridgette acquires 1500m^2 of land in Kaitaia. The land has a 1970s standalone house (non-new build), as well as two new build townhouses. Bridgette takes out a loan of $1m to acquire the land. All three buildings on the land are used as long-term rentals.

The total land area of 1500m^2 is used as follows:

- 400m^2 is used exclusively by the non-new build
- 800m^2 is used exclusively by the two new builds, and
- 300m^2 is a shared outdoor area.

Because the shared outdoor area is used by three residences, two of which are new builds, it is reasonable for Bridgette to apportion the shared outdoor area as ⅔ relating to the new builds. After apportioning the shared outdoor area:

- **500m^2 is not considered new build land.** This is the 400m^2 used exclusively by the non-new build, plus one third of the shared outdoor areas (⅓ x 300m^2 = 100m^2).
- **1000m^2 is considered new build land.** This is the 800m^2 used exclusively by the new builds, and two thirds of the shared outdoor areas (⅔ x 300m^2 = 200m^2).

It would therefore be reasonable for Bridgette to deduct two-thirds of the interest she incurs in relation to the land, because two-thirds of the total land area (1000m^2 of the total 1500m^2) is attributable to the new builds. One-third of the interest she incurs would not be deductible, because it would be attributable to the non-new build portion of the land.

Fact variation: Valuation-based apportionment

Assume similar facts to above, except that Bridgette apportions based on valuation. A valuation for the property has attributed the following values to the land and the residences on it:

- The land (unimproved) is valued at $700,000.
- The non-new build is valued at $250,000.
- The new builds are valued at $450,000.

Applying a valuation-based apportionment method, the following proportion of interest that Bridgette incurs in relation to the land would be deductible:

Valuation for	Value	% of total value of the property	% total interest incurred in relation to the property (to which new build exemption applies)
Land	$700,000	50%	33.33% (since two thirds of the total land area is used by the new builds, only that proportion of the land valuation is attributable to the new builds – ⅔ x 50% is 33.33%)
Non-new build	$250,000	17.86%	0%
New builds	$450,000	32.14%	32.14%
% of total interest incurred in relation to the property that is deductible			**65.47%**

Relationship between the exemptions

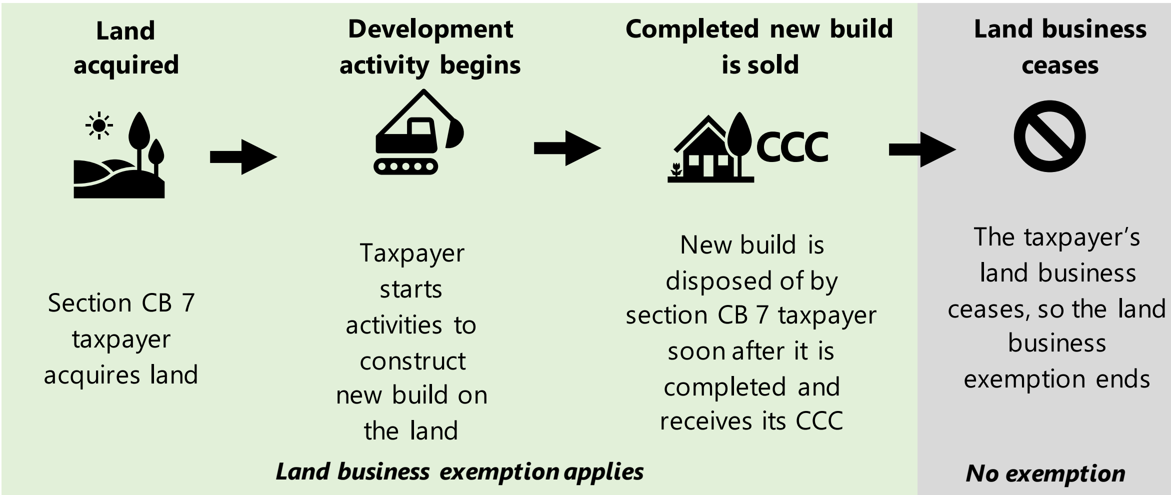
Land business exemption

If the land business exemption applies, the development and new build exemptions will not be relevant for that taxpayer. However, those other exemptions could be relevant to a subsequent purchaser after the taxpayer disposes of the land.

Flowchart 2: Land business exemption

Section CB 7 taxpayer adds new build to land and then disposes of it shortly after CCC is issued

NOTE: THIS FLOWCHART PRESENTS A HIGH-LEVEL OVERVIEW OF KEY CONCEPTS AND MUST BE READ IN CONJUNCTION WITH THE EXPLANATORY TEXT IN THIS SPECIAL REPORT.



What exemption applies for a subsequent purchaser?

If the land business exemption applies to land and the land is later disposed of to another taxpayer, interest incurred by that subsequent taxpayer in relation to the land does not automatically qualify for the land business exemption. If the taxpayer acquiring the land:

- **has a section CB 7 land business and holds the land as part of that business**, then the land business exemption will apply to interest incurred by the taxpayer in relation to the land.
- **does not have a section CB 7 land business but develops, subdivides, or builds on the land for the purpose of creating new build land**, then the development exemption criteria will be met, and interest incurred by the taxpayer in relation to the land may be deductible (subject to normal deductibility criteria – see discussion on nexus above).
- **does not have a section CB 7 land business and does not qualify for the development exemption, but the land is considered 'new build land'**, the new build exemption will apply to interest incurred by the taxpayer in relation to the land (as long as the interest is incurred during the 20-year period the new build exemption applies for).

Development exemption transitions to new build exemption

The development exemption applies to interest incurred in relation to land that is, or was, subject to a person's undertaking or scheme involving development, division, or building for the purpose of creating new build land. Once the land becomes new build land, if the person retains the land, the development exemption would no longer apply and the new build exemption would instead apply to the land.

Flowchart 3: Transition from development exemption to new build exemption

New build added to land and retained by non-section CB 7 taxpayer

NOTE: THIS FLOWCHART PRESENTS A HIGH-LEVEL OVERVIEW OF KEY CONCEPTS AND MUST BE READ IN CONJUNCTION WITH THE EXPLANATORY TEXT IN THIS SPECIAL REPORT.

Land acquired	**Development activity begins**	**Completed new build receives CCC**	**New build exemption ceases**
Taxpayer acquires land	Development exemption starts once undertaking or scheme to develop, subdivide, or build on the land for the purpose of creating a new build commences	CCC Development exemption ceases, new build exemption applies	20 years after the property becomes a 'new build' (normally 20 years after CCC issued)
No exemption	***Development exemption***	***New build exemption***	***No exemption***

If the land is sold, the new build exemption would continue to apply for any subsequent purchaser during the 20-year period that the new build exemption applies for.

Example 23: Land transitions from development exemption to new build exemption

Amber and Sandy buy a large section in Orewa. They purchase the land with the intention of adding new builds to the land, renting these out for a short period, and then selling them off for a profit. Once they start an undertaking or scheme to develop and build on the land to add new builds, they qualify for the development exemption.

After construction is complete, the new builds receive their CCCs. At this point, the development exemption ceases to apply to the land, and instead, the new build exemption starts to apply. The new build exemption will continue to apply to the land until 20 years have passed from the date the new builds received their CCCs.

Three years after the residences receive their CCCs, Amber and Sandy sell the land to James. The new build exemption continues to apply to the land, but it will only apply for another 17 years – the 20-year exemption period does not reset when the land is sold.

Exemptions may apply concurrently for two taxpayers

Sometimes, the new build exemption can apply for the purchaser of a new build at the same time the land business or development exemption applies for another taxpayer that is developing the land. This will usually occur where a new build is purchased off the plans (that is, before it is constructed).

When a new build is purchased off the plans:

- The developer or builder may qualify for the land business or development exemption while they are adding the new build to the land.
- The purchaser may also qualify for the new build exemption while the new build is being added to the land if they have already acquired an interest in the land. (Although note that a nexus would be required for the interest to be deductible, even if the new build exemption applies.)

Example 24: Exemptions apply concurrently for land business taxpayer and purchaser

Neo and Archie own a large property development business, Neo-Archie Homes Ltd, that specialises in building property sold off the plans during construction. They acquire some former farmland in South Wairarapa that they intend to subdivide and construct new builds on. On 1 October 2021, Bagheera enters into an agreement to buy a new build from Neo-Archie Homes Ltd. The new builds are still being constructed and do not receive their CCCs until 24 October 2022. On 31 October 2022, title for Bagheera's new build is registered to him.

Neo-Archie Homes Ltd

The land business exemption applies to Neo-Archie Homes Ltd while it holds the land. This is because it holds the land as part of a land-related business.

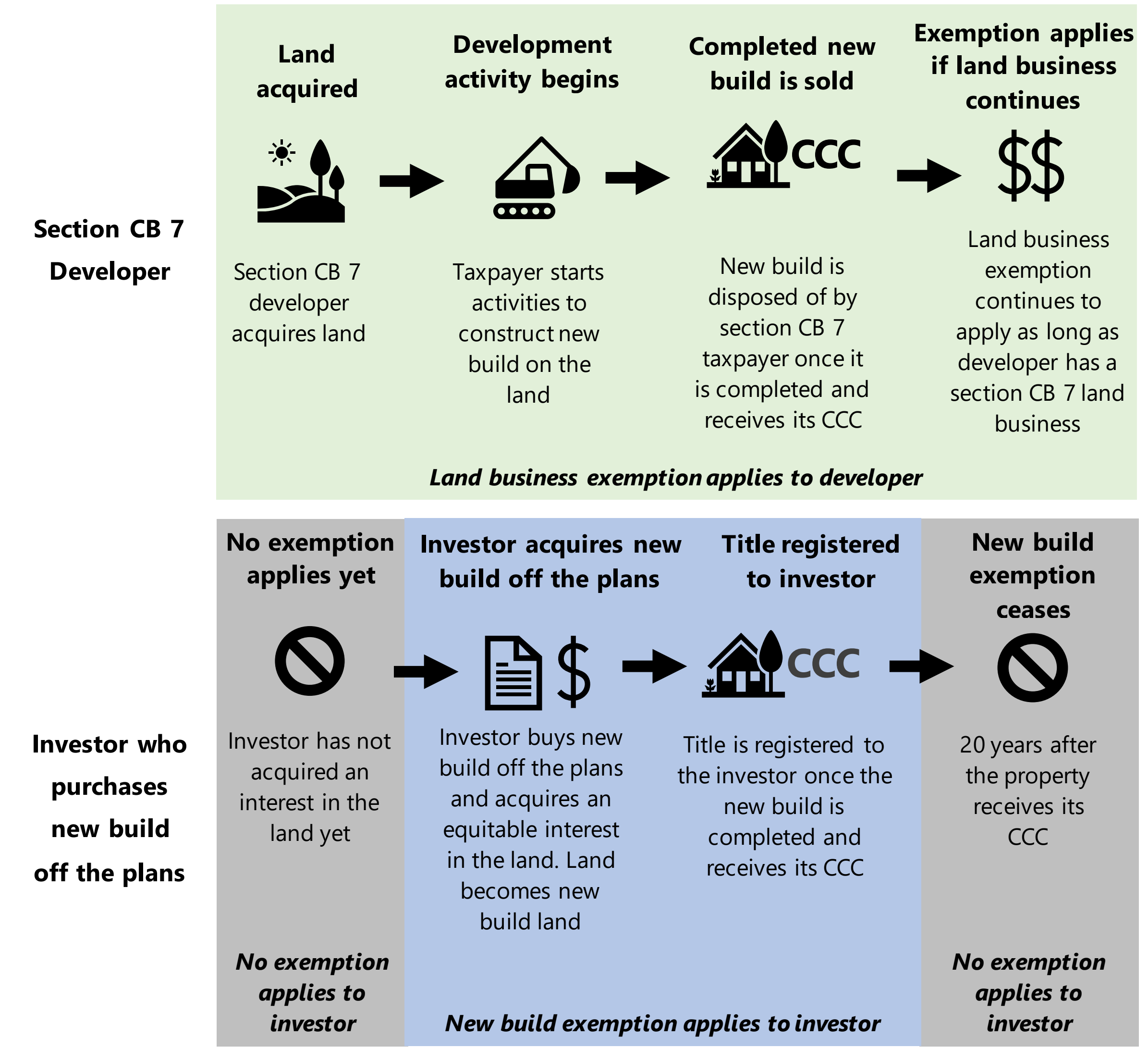
Bagheera

Bagheera will meet the criteria for the new build exemption from 1 October 2021 because he has acquired a new build off the plans. He would therefore potentially be able to deduct interest from that date, but only if he satisfies the normal deductibility requirements under existing tax rules. The new build exemption will apply to the land until 23 October 2042, 20 years after the new build received its CCC.

Flowchart 4: Exemptions may apply concurrently

New build is purchased by an investor off the plans from a section CB 7 property developer

NOTE: THIS FLOWCHART PRESENTS A HIGH-LEVEL OVERVIEW OF KEY CONCEPTS AND MUST BE READ IN CONJUNCTION WITH THE EXPLANATORY TEXT IN THIS SPECIAL REPORT.



Land business exemption

Section DH 4(2) of the Income Tax Act 2007

The land business exemption is aimed at ensuring the interest limitation rules do not negatively impact upon new housing supply. The exemption applies to interest for all land to which section CB 7 applies, even if there is no active development, division, or building work occurring on the land at the time. This is because of the significant role section CB 7 land businesses play in providing new housing stock, and because it is likely that section CB 7 taxpayers have multiple plots of land with different debt funding relating to a number of them.

Key features

The key features of the land business exemption are discussed above in the "Exemptions for new housing supply – overview" section of this special report.

Application date

The land business exemption came into force on 27 March 2021 and applies to interest incurred on or after 1 October 2021. However, the exemption may apply for a given taxpayer from a later date, depending on when the section CB 7 land is acquired – refer to the discussion under the "*Land business exemption start and end date*" heading below.

Detailed analysis

Exemption applies to land businesses

An exemption from the interest limitation rules applies to the extent interest is incurred by a taxpayer in relation to land held by that taxpayer as part of a business described in section CB 7. This exemption is set out in section DH 4(2) and is referred to as the "land business exemption."

The following businesses are described in section CB 7:

- dealing in land
- developing land
- dividing land into lots, and
- erecting buildings.

Practically, this means people who are professional land dealers, land developers or engaged in land subdivision will qualify for the land business exemption for interest incurred for the land they acquire and hold as part of their land business. Additionally, professional builders who acquire land for their business and make improvements to the land will also qualify for the land business exemption, provided they meet the requirements of section CB 7.

Example 25: Land developed by taxpayer with land-related business

XD Developers is a company that regularly buys land, develops the land into residential subdivisions and sells the divided lots to buyers. XD Developers is a land-related business, and the sale of its land is taxable under section CB 7.

XD Developers decides to acquire a new piece of land for property development. It obtains a loan from Big Bank to buy the land, and Big Bank obtains security over the land.

Once XD Developers commences the development activity, it obtains further funding from Big Bank to help with its development expenses. Since XD Developers is a land-related business and has acquired the property for the business, the land business exemption applies. All interest on the loans obtained from Big Bank for the land will be deductible.

Land not originally acquired for section CB 7 land business

If a person does not acquire land for a land-related business but later forms an intention to develop the land, the land business exemption will not apply. Instead, the person will need to meet the requirements of the development exemption to avoid the application of the interest limitation rules (see the "Development exemption" section of this special report for more information).

Taxpayer with both section CB 7 and non-section CB 7 land

If a taxpayer holds a mixture of section CB 7 and non-section CB 7 land, the land business exemption will not apply to all the taxpayer's land. The exemption only applies to the section CB 7 land held by the taxpayer. The interest limitation rules will apply to the taxpayer's non-section CB 7 land unless another exemption (such as the development or new build exemption) applies.

Example 26: Rental property retained by taxpayer with land-related business

Jones Co is a business that subdivides rural land and sells it to property developers, who in turn develop and build on the land. Therefore, Jones Co's income from disposing of the land held in the business is subject to tax under section CB 7.

Since section CB 7 applies, the land business exemption will apply as soon as Jones Co purchases the land for its business and will continue to apply for long as Jones Co continues its land-related business. The exemption will apply to interest incurred on all borrowings for land acquired for Jones Co's business.

On one occasion, Jones Co decides to acquire land to try its hand at building a house to keep and rent out long term. In so doing, the relevant land is not held on revenue account under section CB 7. The land business exemption will therefore not apply.

The criteria for the development exemption may be met until the time the new build added to the land receives a code compliance certificate (CCC). However, even if the criteria are met, interest will only be deductible if the normal deductibility rules are satisfied - that is, there must be a nexus with income derived. Once a CCC has been issued, the new build exemption will apply.

Remediating or renovating older houses

Where a taxpayer's section CB 7 land business involves remediating or renovating older houses for sale, the exemption will also apply to interest incurred on borrowings used in relation to that business. This is a unique feature of the land business exemption. The development and new build exemptions do not apply to interest incurred on remediating or renovating non-new builds, except to the extent the repairs or renovation work relate to remediating an earthquake prone or leaky building (see the "New build exemption" section of this special report for more information).

Example 27: Renovating properties

Rainbow Builders Ltd (RB) has a business of buying old properties, adding new features, and selling the properties for a profit. RB acquires a large number of old villas in an older neighbourhood to renovate and on sell. RB modernises the properties by updating their electrical systems and refitting their kitchens and bathrooms with new fixtures. RB also repaints the interiors and adds new decks to each of the properties.

RB acquired the portfolio of villas to renovate and sell them as part of a land-dealing business under section CB 7, so the interest RB incurs for the properties will qualify for the land business exemption. All interest incurred for loans to acquire the villas, hold them, and renovate them will be deductible and not subject to the new interest limitation rules.

Land business exemption start and end date

The exemption starts from the date section CB 7 land is acquired by a taxpayer and ends when the taxpayer ceases to have a section CB 7 land business. So, if a taxpayer has land to which section CB 7 applies and then disposes of that land, the land business exemption will continue to apply for interest incurred in relation to that land. For example, if the land is sold at a loss and the sale proceeds do not fund complete repayment of the loan, some debt relating to the land may remain after its sale. The exemption will continue as long as the taxpayer still has a section CB 7 land business. When the taxpayer's section CB 7 land business ceases, the exemption will cease to apply as well.

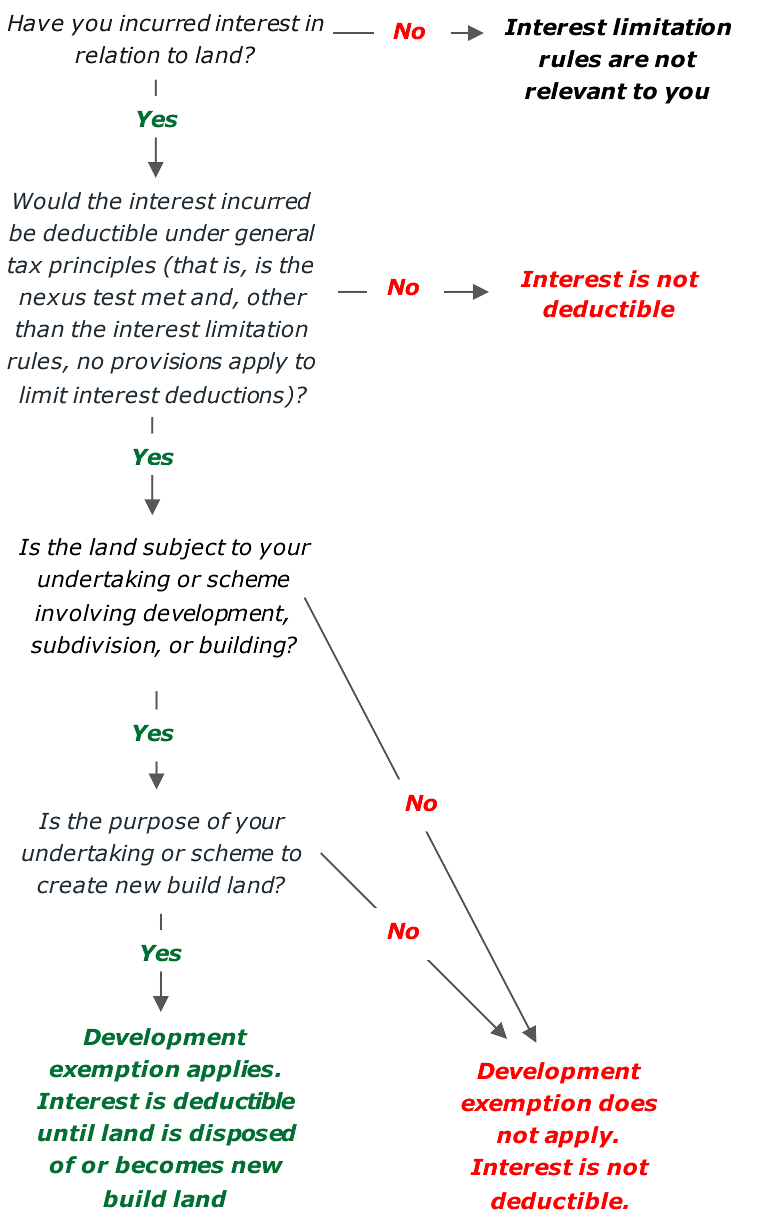
Development exemption

Sections DH 4(3), DH 5(7), and YA 1 of the Income Tax Act 2007

The development exemption is aimed at ensuring the interest limitation rules do not negatively impact upon activity that creates new housing supply. The exemption applies to interest a person incurs for development, subdivision or building activity undertaken to create new build land.

Flowchart 5: Development exemption

NOTE: THIS FLOWCHART PRESENTS A HIGH-LEVEL OVERVIEW OF KEY CONCEPTS AND MUST BE READ IN CONJUNCTION WITH THE EXPLANATORY TEXT IN THIS SPECIAL REPORT.



Key features

The key features of the development exemption are discussed above in the "Exemptions for new housing supply – overview" section of this special report.

Application date

The development exemption came into force on 27 March 2021 and applies to interest incurred on or after 1 October 2021. However, the exemption may apply for a given taxpayer from a later date, depending on when the taxpayer's undertaking or scheme to develop the land begins – refer to the discussion under the "*Development exemption start and end date*" heading below.

Detailed analysis

An exemption from the interest limitation rules applies for interest a person incurs in relation to an undertaking or scheme involving developing, subdividing or building for the purpose of creating new build land. This exemption is set out in section DH 4(3) and is referred to as the "development exemption". The activities to which the development exemption applies (developing, dividing, and building) are referred to as "development" below.

Unlike the land business exemption,[15] the development exemption applies to interest incurred by a person developing land where section CB 7 does not apply.

Undertaking or scheme

The exemption applies to the extent the interest incurred is in relation to land subject to an undertaking or scheme involving development, subdivision, or building to create new build land. The existing meaning of "undertaking or scheme", as used in section CB 12, applies. An undertaking or scheme is a plan, design or program of action devised to attain some end result. For the development exemption, it is sufficient to demonstrate a coherent plan or purpose that involves a series of steps to create new build land.

Example 28: Undertaking or scheme

Brooke owns and manages ten residential rental properties. She also owns a large section of land that she decides to subdivide and build five additional townhouses on. She plans to sell the townhouses.

The development exemption begins when Brooke's undertaking or scheme to subdivide the land begins. For example, it may start once Brooke engages a company to survey the land and prepare the subdivision plan. When an undertaking or scheme begins will depend on the facts of each case.

Fact variation: Subdivision with no intention to create new build land

Assume the same facts, except that Brooke decides to subdivide the large section of land but has no intention of creating new build land herself. After she subdivides the section, Brooke sells it to a property developer. The development exemption does not apply to the land because Brooke subdivided the land without an intention to create new build land.

Development exemption start and end date

The exemption applies from the date an undertaking or scheme to develop, subdivide or a build on the land for the purpose of creating new build land begins.

[15] See the "Land business exemption" section of this special report for more information.

It will end for the person undertaking the development once the land becomes new build land if the person retains the land. Land would generally become 'new build land' when a code compliance certificate (CCC) is issued for a self-contained residence or abode that has been added to the land, provided the CCC is issued on or after 27 March 2020 (for more information, see the "Definition of 'new build land'" section of this special report).

Example 29: Transition from development exemption to new build exemption

Abigail is engaged in the development of a new self-contained residence. While Abigail is in the process of developing these "new builds", the development exemption will apply. However, Abigail will only be able to deduct interest under this exemption if the general deduction criteria set out in existing tax rules are met. Once the new self-contained residence has received its CCC, the development exemption will cease to apply, and the new build exemption will apply to the land instead.

The development exemption may still apply to interest on debt if the development has been sold at a loss and the proceeds were insufficient to repay all the debt, such that interest is still being incurred after the land is disposed of. However, in most cases interest will not be deductible after the land is disposed of it because the nexus test will not be met.

Definition of "new build land"

Sections DH 5(7) and YA 1 of the Income Tax Act 2007

A definition of "new build land" has been introduced for the purposes of the new build exemption from interest limitation[16] and the 5-year new build bright-line test[17]. The definition is also relevant to the development exemption from interest limitation[18].

New build land is generally defined to mean land to which a self-contained residence or abode has been added, provided a Code Compliance Certificate (CCC) is issued on or after 27 March 2020 showing that the residence/abode has been added to the land (although some exceptions apply, as discussed below).

[16] See the "New build exemption" section of this special report.
[17] See the "5-year new build bright-line test" section of this special report.
[18] See the "Development exemption" section of this special report.

Key features

"New build land" is defined in new section DH 5(7) to mean land to the extent to which it has a place configured as a self-contained residence or abode (self-contained residence), provided one or more of the following paragraphs in section DH 5(7) are satisfied:

Description	Examples	Section
A CCC has been issued on or after 27 March 2020 evidencing that the **place was added to the land.**	*A self-contained residence is constructed on (or relocated onto) the land.*	DH 5(7)(a)
A CCC has been issued on or after 27 March 2020 evidencing a **place already on the land has been converted** into the self-contained residence.	*A commercial building is converted into one or more self-contained residences.* *An existing home is converted into two or more self-contained residences.*	DH 5(7)(a)
Local or building consent authority[19] records show that the **conversion of the place from a hotel or motel** into one or more self-contained residences was completed on or after 27 March 2020.	*A hotel is converted into individual self-contained units or apartments.*	DH 5(7)(d)
The place was **removed from the earthquake-prone buildings (EPB) register** on or after 27 March 2020, and either: received a CCC on or after 27 March 2020 evidencing that building work to remediate the place is complete, or local or building consent authority records show that the building work to remediate the place was completed on or after 27 March 2020 and was verified by a suitably qualified engineer.	*An existing apartment block that is on the EPB register is remediated and then removed from the register.*	DH 5(7)(e)
The place was **not previously weathertight**, but a CCC has been issued on or after 27 March 2020 evidencing that **at least 75% of the place's cladding has been replaced**.	*An existing self-contained residence that has weathertightness issues is re-clad to fix those issues.*	DH 5(7)(f)

[19] "Building consent authority" has the meaning given to it in the Building Act 2004.

Includes exclusive areas and some shared areas (section DH 5(7)(b))

New build land includes any areas of land that are exclusively used by residents of the self-contained residence. It also includes a reasonable proportion of shared areas of land that are appurtenant to the residence.

Agreement to add residence to land (section DH 5(7)(c))

For the purposes of the new build exemption from interest limitation, new build land includes land for which there is an agreement to add a self-contained residence, provided a CCC will be issued on or after 27 March 2020 evidencing the place was added to the land. This inclusion does not apply for the purposes of the new build bright-line test (see section CB 6A(1)(b)(iii)).

Application date

The definition of new build land applies:

- To residential land acquired on or after 27 March 2021 for the purposes of the new build bright-line test.[20]
- From 1 October 2021 for the purposes of the new build exemption from interest limitation, regardless of when the land is acquired.

Detailed analysis

"To the extent" means apportionment may be required

The definition of new build land in section DH 5(7) mentions the words "to the extent". For example, paragraph (a) of the definition says:

> [New build land] means land **to the extent** to which it has a place that is configured as a self-contained residence or abode, if a code compliance certificate has been issued on or after 27 March 2020 evidencing that the place was added to the land or converted into a residence or abode;

The inclusion of the words "to the extent" means that sometimes only part of a piece of land may be new build land. How land that is only partially new build land should be apportioned

[20] But not to residential land acquired on or after 27 March 2021 as a result of an offer made by the purchaser on or before 23 March 2021, provided the offer could not be revoked before 27 March 2021.

for the new build exemption from interest limitation is covered in the "Exemptions for new housing supply – overview" section of this special report. See the "5-year new build bright-line test" section for more information on how to apportion for the purposes of that test.

Self-contained residence

Land can only satisfy the definition of new build land if there is a place that is configured as a self-contained residence on the land.

'Self-contained' is not explicitly defined in the legislation, but it is intended to mean a place that is able to be lived in by a single household, without that household having to share essential facilities, such as a kitchen or bathroom, with another household.

Example 30: Place with shared kitchen facilities

Kate owns land with an existing self-contained residence on it. The land is not new build land, as the residence was completed and received its CCC before 27 March 2020.

Kate adds a sleepout, which she intends to rent out, behind the existing residence. The sleepout can function as an extra bedroom and has its own bathroom, but it does not have its own kitchen. Anyone living in the sleepout would have to use the kitchen located in the existing dwelling.

Having no kitchen means the sleepout is not self-contained. Therefore, the land is not considered new build land after the sleepout is added to it.

Land that has a place on it that was not previously self-contained, such as a sleepout, may qualify as new build land if the place later becomes self-contained.

Example 31: Sleepout converted to self-contained residence

Assume same facts as in example 30 above. Six months after she builds the sleepout, Kate adds a kitchen to it. The building work to turn the sleepout into a self-contained residence receives a CCC on 20 December 2021.

The following areas of land would be considered new build land:

- the area the new self-contained residence (the sleepout) is on

- land used exclusively by the residents of the sleepout, such as an exclusive outdoor garden or patio area, and
- a reasonable proportion of any shared areas, such as a driveway that is shared with the other residence on the land.

The remainder of the land would be attributable to the existing residence (not the new self-contained residence that was formerly a sleepout), so would not be considered new build land.

Even if some areas of a property are shared with other household units, a residence may still be considered self-contained as long as it has its own essential facilities.

For example, a residence could be considered self-contained even if it shares the following facilities/areas with other residences/places:

- **A landing or entranceway.** For example, where the front doors in a block of apartments or units come off the same landing or entranceway.
- **Laundry facilities.** For example, where a block of four units all have access to a shared room that has a communal washing machine and dryer, or all share an outdoor washing line.
- **Recreational facilities**. For example, a swimming pool or a shared exercise room/gymnasium.
- **Outdoor areas**. For example, a shared outdoor entertainment area, driveway, or garden area.

Example 32: Apartment block with communal facilities

Amber owns an apartment in a five-storey apartment block. The apartment has its own kitchen and bathroom facilities, and its front door is located on a landing that is shared with three other apartments (with the landing accessible by stairs or lift).

All the apartments in the block share a ground floor lobby area, stairs, and a lift. Occupants of all the apartments can use a shared gymnasium and pool, as well as a small room that contains washing machines and driers.

Amber's apartment is considered "self-contained", even though she shares some areas and facilities with other residents of the apartment block.

A residence that shares a utilities connection with another residence may also be considered self-contained.

Example 33: Internal access door and shared utilities connections

Blair owns a large two-storey house. It has two kitchens, three bathrooms and five bedrooms. Upstairs there is one kitchen, two bathrooms and four bedrooms. The remaining kitchen, bathroom and bedroom are downstairs. The downstairs area (the flat) can be locked off from the rest of the house via a lockable internal door.

A firewall separates the flat from the main house. It has its own front door, which opens out to a shared front garden area. The flat and main house share power and water connections.

The flat is a self-contained residence. It is capable of being rented out and occupied by a single household unit, without the household in the flat having to share any essential facilities with residents of the main house. It does not matter that there is an internal door through which the flat can be accessed by the main home, because that internal door can be locked when the flat is being rented out. It also does not matter that the power and water connections are shared by the flat and main house.

Materials used and type of new build

It does not matter what size a self-contained residence added to the land is for the purposes of determining whether the land is new build land. For example, adding a tiny home to land would enable the land to qualify as new build land (as long as the home is self-contained and receives a CCC on or after 27 March 2020 showing that it has been added to the land).

The materials used to construct a residence on new build land are also irrelevant. Brand new materials or recycled/reclaimed materials could be used in the construction of the residence, provided the property is still able to obtain its CCC (or satisfy the local/building consent authority record requirements in sections DH 5(7)(d) and (e)(ii) if these provisions apply). An older house that is relocated onto the land may also enable the land to qualify as new build land.

Example 34: New build constructed off-site using reclaimed materials

Sandy has a tiny home constructed off-site from reclaimed materials. The tiny home contains its own kitchen and bathroom facilities. When construction is complete, Sandy adds the tiny home to her residential land, and it receives its CCC on 22 February 2021 evidencing that it has been added to the land. As the tiny home is self-contained and received its CCC after 27 March 2020, Sandy's land qualifies as new build land.

27 March 2020 date

The definition of "new build land" requires there to be proof that a self-contained residence was either added to the land or converted from an existing place on the land. The proof required is generally a CCC issued on or after 27 March 2020. However, for hotel/motel conversions and EPBs that are remediated, other records held by a local authority or building consent authority can be used instead of a CCC.

Date of acquisition not relevant

The acquisition date of the land is not relevant to determine whether land can qualify as new build land. Instead, the date a residence on the land receives its CCC will generally be what is important.

Example 35: Date of acquisition irrelevant

Mark acquires residential land on 1 November 2019. He adds a self-contained dwelling to the land that is completed and receives its CCC on 31 March 2020. The land that the self-contained dwelling has been added to qualifies as new build land because the dwelling's CCC was issued after 27 March 2020. It does not matter that Mark acquired the land before 27 March 2020, as the date of acquisition is not relevant to whether the land satisfies the definition of new build land.

Added to the land (section DH 5(7)(a))

"Added to the land" includes where:

- a new residence is constructed on the land
- a modular home is added to the land, and
- an older home is relocated onto the land.

It does not matter whether there is an existing residence on the same title, or whether the residence that is added to the land is standalone or attached[21] to another residence on the land.

Example 36: New self-contained residence added to land

Linda owns a rental property in Opaki that received its CCC in the 1980s. She adds a second self-contained residence that is attached to the existing rental property. The new self-contained residence receives its CCC on 11 February 2022. The portion of the land attributable to the new self-contained residence is considered new build land.

Existing house moved to enable new development

Land may qualify as new build land because a self-contained residence that is already on it is shifted from one position to another but remains on the land (provided a CCC is issued on or after 27 March 2020 evidencing the residence was added to the new location on the land).

This may occur, for example, where an existing house is shifted to make room for one or more new self-contained residences a taxpayer is adding to the land.

Example 37: Existing home relocated to make room for new residences

James owns a sizeable section in Lower Hutt that has a 1930s bungalow in the middle of it. In October 2022, he relocates the bungalow to the north-west corner of the section. A CCC is issued once the work necessary to finish relocating the bungalow is completed. James then adds three new self-contained residences to the section. They all receive their CCCs in due course.

The entire section is considered new build land. It does not matter that the bungalow is not made of brand-new materials, or that it was relocated on the same section.

Fact variation: Relocation to enable subdivision

After shifting the bungalow, James decides he does not want to continue with the development himself. He subdivides the section into four, and then sells off each parcel of land separately. The parcel of land that the bungalow is on is considered new build land because it has a self-contained place on it that received its CCC on or after

[21] For example, a new residence added to the land could be added below, above, or to the side of an existing residence on the land.

27 March 2020. However, the three other parcels of land do not qualify as new build land as they are bare land and do not have self-contained residences.

If a place was relocated on the same piece of land just to gain the benefit of the new build exemption or to qualify for the 5-year new build bright-line test instead of the 10-year test, this would be considered tax avoidance.

Conversion into a self-contained residence (section DH 5(7)(a))

Section DH 5(7)(a) includes conversions where:

- An existing home is converted so that where there was one residence there are now two or more self-contained residences.

Example 38: Existing home converted into two self-contained residences

Felicity owns a large two-storey character home on a moderately sized residential section in Thorndon. After permanently moving to the Wairarapa, she decides to rent out the Thorndon property. Before she rents it out, Felicity decides to convert the home into two self-contained residences, so that she can rent the property out to two different households.

She separates the two storeys, adding in a firewall between them. She adds a kitchen to the second storey (the first storey has the original kitchen), as well as two new bathrooms. She then adds an external staircase and a front door to the second level, so that it has its own entrance. The bottom level is able to use the original front door for the house. After the renovations, each floor is a self-contained residence capable of being lived in long term by a household unit. A CCC is issued on 31 October 2021 evidencing that the conversion of the home has been completed.

No apportionment is required between those parts of the residences that are newly added and those parts that were from the original home. The entire section is considered new build land.

- An existing residential building is converted, so that there is now a self-contained residence where there was not one previously (see examples 30 and 31 above regarding the converted sleepout).
- An existing commercial building is converted into one or more self-contained residences.

Example 39: Commercial to residential conversions

Shirley & Susan Homes Ltd (SSH) purchases a central city office block in Auckland CBD that it converts into 25 small self-contained apartments. A CCC is issued on 14 February 2022 that confirms the building work to convert the office block into apartments is complete. The land that the apartment block is on is considered new build land from 14 February 2022, the date the self-contained residences received their CCCs.

After a conversion has occurred, the land is considered new build land to the extent it has a self-contained residence on it that received a CCC on or after 27 March 2020 confirming this.

Exclusive areas and reasonable proportion of shared areas (section DH 5(7)(b))

New build land includes any areas of land exclusively used by the residents of the self-contained residence added to or converted on the land. It also includes a reasonable proportion of any shared areas of land appurtenant to the place. The legislation does not require that a particular approach to apportionment be taken, but consistent with existing apportionment principles, the apportionment must be done on a fair and reasonable basis.

Example 40: Reasonable proportion of shared areas

Cicillia owns a home and income property. It is on a 950m^2 section in Auckland. She lives in the larger home on the property and rents out a smaller self-contained unit, which received its CCC in June 2021. Both dwellings are one storey. The land is made up of the following areas:

Description	Land area	Used by	New build land?
Floor area of the main home	200m^2	Main home	No
Outdoor areas exclusively used by residents of the main home	300m^2	Main home	No
Front garden area shared by residents of both the main home and the unit	200m^2	Main home and unit	Yes – 100m^2

Driveway and parking area shared by residents of both the main home and the unit	100m^2	Main home and unit	Yes – 50m^2
Floor area of the unit	100m^2	Unit	Yes – 100m^2
Outdoor areas exclusively used by residents of the unit	50m^2	Unit	Yes – 50m^2
Total new build land area			**300m^2**

Exclusive areas attributable to the unit are considered new build land. This includes the floor area of the unit itself (100m^2) plus the unit's exclusive outdoor areas (50m^2). The unit shares the front garden area and driveway/parking area with just one other home, so it is reasonable to attribute 50% of those shared areas to the unit. Applying this approach, 300m^2 of Cicillia's land is considered new build land. The remaining 650m^2 is not considered new build land.

Off the plans purchases (section DH 5(7)(c))

Under section DH 5(7)(c), new build land includes land for which there is an agreement to add a self-contained residence, provided a CCC will be issued on or after 27 March 2020 evidencing the place was added to the land.

Example 41: Agreement to add self-contained residence to land

Josephine decides to invest in a new rental property. She enters into an agreement to purchase a new self-contained residence off the plans from a property developer. Under that agreement, title will be transferred to Josephine once the construction of the self-contained residence on the land is complete and a CCC has been issued. For the purposes of the new build exemption from interest limitation, the land is new build land from the date Josephine enters into the agreement.

However, it is important to note that while the section DH 5(7)(c) definition of "new build land" includes off-the-plans purchases, that part of the definition is explicitly excluded for the purposes of the 5-year new build bright-line test (see section CB 6A(1)(b)(iii)). In other words, land that only qualifies as new build land because of section DH 5(7)(c) will not qualify as new build land for the new build bright-line test.

Hotel or motel conversions (section DH 5(7)(d))

Section DH 5(7)(d) provides that land that previously had a hotel or motel on it qualifies as new build land if:

- the hotel or motel is converted into self-contained residences, and
- the conversion is recorded in the records of a local authority or building consent authority as having been completed on or after 27 March 2020.

While section DH 5(7)(a) already allows for commercial to residential conversions to qualify, section DH 5(7)(d) removes the CCC requirement for hotels or motels that are converted on or after 27 March 2020.

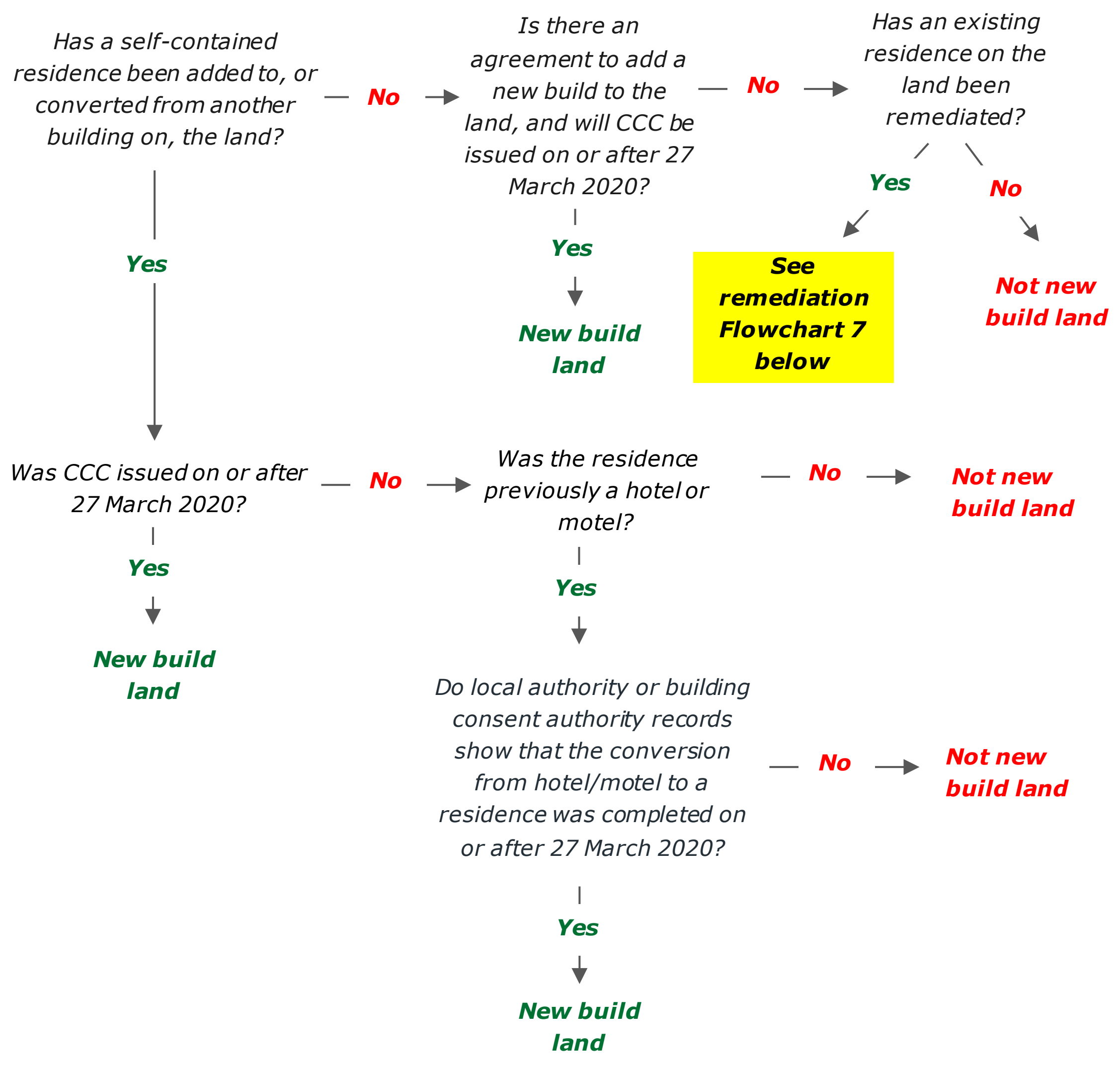
Hotels and motels are already used for short-stay accommodation, and they often already have cooking facilities and bathrooms. Compared with other conversions, less work may be required to convert a hotel or motel into self-contained residences. This may mean no CCC is issued once the conversion is completed. For this reason, an exception to the CCC requirement applies for hotels and motels that are converted into self-contained residences.

Example 42: Motel converted into apartments

In December 2020, Chris decides to convert his motel into self-contained apartments. The motel units already have bathrooms and cooking facilities, so only a small amount of work is required to make the units suitable for long-term rental accommodation. After the renovations are complete, Chris notifies his local council (which is a local/building consent authority) that his motel units will be used as residential apartments going forward. The conversion of the motel units is noted in the council's records. The land the former motel units are on is considered new build land from the date the records show the conversion was completed.

Flowchart 6: New builds added to, or converted on, land

NOTE: THIS FLOWCHART PRESENTS A HIGH-LEVEL OVERVIEW OF KEY CONCEPTS AND MUST BE READ IN CONJUNCTION WITH THE EXPLANATORY TEXT IN THIS SPECIAL REPORT.



Remediation of existing residences (sections DH 5(7)(e) and (f))

Land with existing self-contained residences that are remediated may qualify as new build land in two circumstances:

- where they were on the earthquake prone buildings (EPB) register but have been remediated and removed from the register, or
- where they had weathertightness issues but have been at least 75% reclad.

These two categories of land qualify as new build land because the amount of building work required to remediate the existing residences on the land will generally be significant.

Furthermore, it is objectively verifiable that these residences required remediation, and that they have subsequently been remediated. This ensures that Inland Revenue and taxpayers can clearly identify whether land is new build land. This is important because the new build exemption from interest limitation applies for 20 years and applies to subsequent purchasers of the land during this period.

EPBs (section DH 5(7)(e))

To the extent land has a self-contained residence that is removed from the EPB register[22] on or after 27 March 2020, the land is new build land if:

- a CCC is issued on or after 27 March 2020 evidencing the building work to remediate the residence is complete, or
- local or building consent authority records show that the building work to remediate the residence was completed on or after 27 March 2020 and that this has been verified by a suitably qualified engineer.

Section DH 5(7)(e)(ii) (bullet point 2 above) provides an exception to the CCC requirement because, in some circumstances, remediation of an EPB may not result in a CCC being issued. However, to qualify as new build land, local or building consent authority records must show that:

- the remediation was completed on or after 27 March 2020, and
- the building work to remediate the building was verified by a suitably qualified engineer.

Example 43: Remediation of apartment building on EPB register

Robin has an apartment in an apartment building in Wellington that is on the EPB register. Robin and the owners of the other apartments in the building agree to proceed with building work to remediate the apartment building. Over a period of 12 months, building work to remediate the apartments takes place. On 30 June 2021, a CCC is issued confirming that the building work has been completed. The apartment

[22] "EPB register" has the meaning given to it in the Building Act 2004.

building is removed from the EPB register. The apartments are considered new build land from this date.

Residence with weathertightness issues (section DH 5(7)(f))

To the extent land has an existing self-contained residence that is remediated for weathertightness issues, the land will qualify as new build land provided:

- at least 75% of the residence is reclad, and
- a CCC is issued on or after 27 March 2020 evidencing that the cladding has been replaced.

It does not matter whether the residence is standalone or if (for example) it is part of an apartment block.

Requiring at least 75% of a residence to be reclad ensures that only land with a residence that has had significant weathertightness issues – and has been substantially reclad – will qualify as new build land.

Example 44: Leaky home remediated

Miranda owns a self-contained residence in Auckland that has significant weathertightness issues. It needs to be completely reclad, and large amounts of its interior need to be completely replaced because of mould and rot. Miranda arranges for the work to be done. A CCC is issued on 20 December 2020 evidencing that the residence has been at least 75% reclad, and that various other building work has been undertaken to remediate the property. The land that the residence is on is considered new build land from this date.

Fact variation: Only portion of home reclad

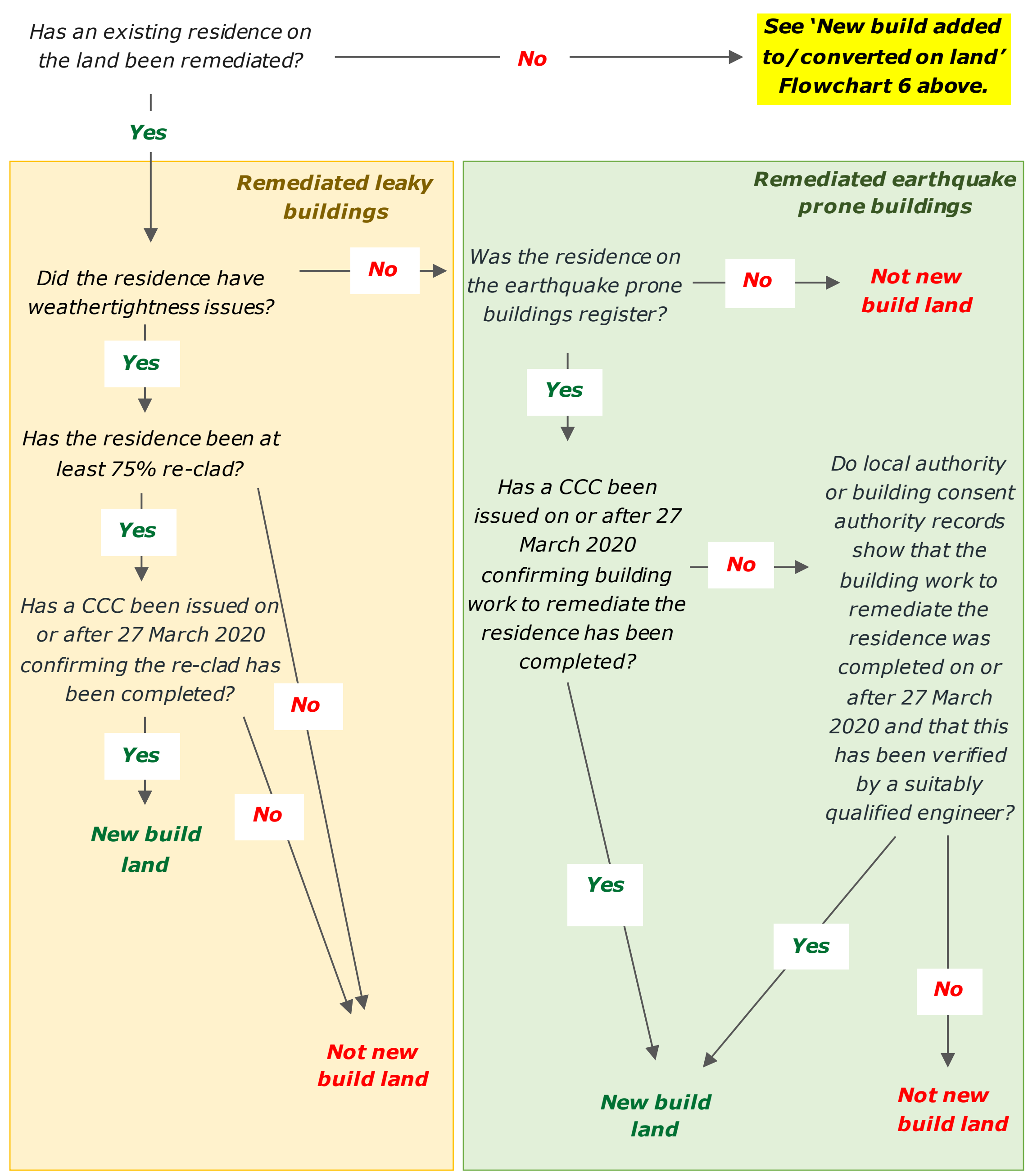
Steve owns a self-contained residence in Wellington that was built from native timber in the 1920s. In the 1990s, before Steve bought it, an extra couple of rooms were added to the residence. Unfortunately, in recent years Steve has discovered that the extra rooms were poorly constructed and have weathertightness issues.

Steve pays a builder to re-clad the extra rooms that were added to the residence. While Steve has re-clad the entire portion of the residence that was leaky, he has only reclad a quarter of the residence overall because most of the residence was not leaky.

The land that the residence is on does not qualify as new build land after the re-clad. This is because at least 75% of the residence would have to have been re-clad to qualify.

Flowchart 7: Existing residence that has been remediated

NOTE: THIS FLOWCHART PRESENTS A HIGH-LEVEL OVERVIEW OF KEY CONCEPTS AND MUST BE READ IN CONJUNCTION WITH THE EXPLANATORY TEXT IN THIS SPECIAL REPORT.



New build exemption

Sections DH 4(1), DH 5(7), and YA 1 of the Income Tax Act 2007

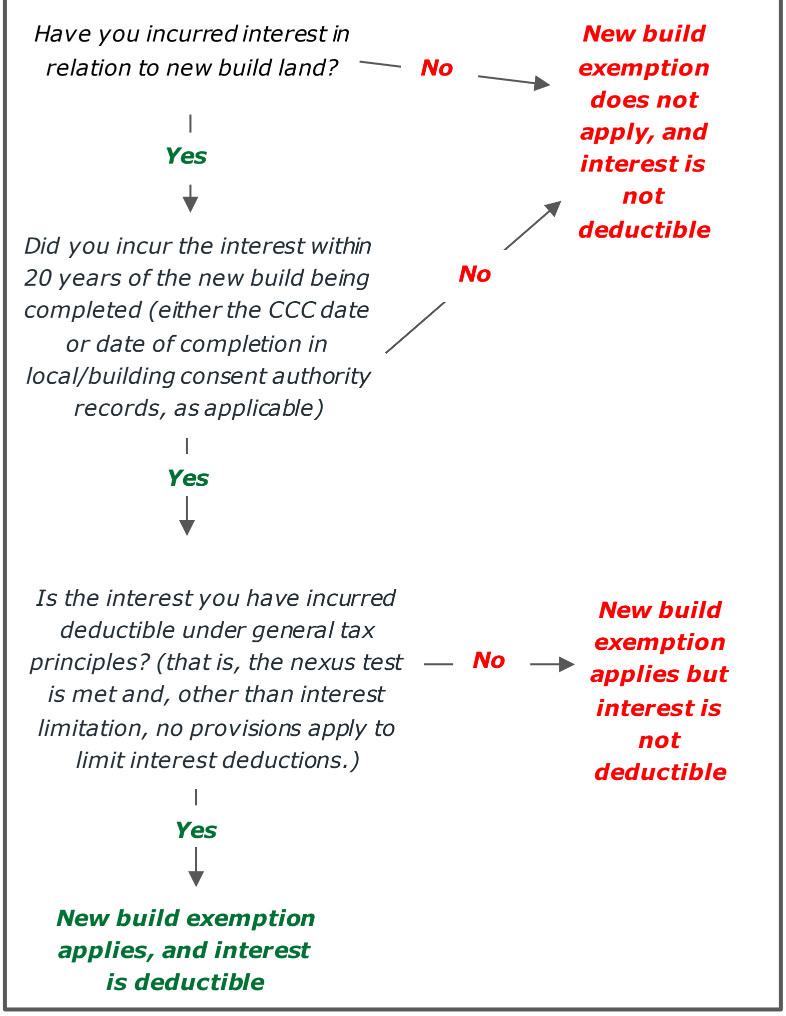
The new build exemption applies to new build land and provides a 20-year exemption from the interest limitation rules for interest incurred in relation to the land. The exemption is aimed at ensuring interest limitation does not negatively impact on new housing supply.

Key features

The key features of the new build exemption are discussed above in the "Exemptions for new housing supply – overview" section of this special report. You may also find it useful to read the section on the "Definition of 'new build land'" before reading this section.

Flowchart 8: New build exemption

NOTE: THIS FLOWCHART PRESENTS A HIGH-LEVEL OVERVIEW OF KEY CONCEPTS AND MUST BE READ IN CONJUNCTION WITH THE EXPLANATORY TEXT IN THIS SPECIAL REPORT.



Application date

The new build exemption applies to interest incurred in relation to new build land from 1 October 2021. However, the exemption may apply from a different date for interest incurred by a given taxpayer, depending on when the taxpayer acquires the land and when the land becomes new build land. Generally, the exemption starts to apply to interest incurred in relation to land once a CCC for a new build on the land is issued, although some exceptions apply.

Detailed analysis

Section DH 4(1) provides that the new interest limitation rules in subpart DH do not apply to interest incurred by a person to the extent it is incurred in relation to new build land.

The exemption from the interest limitation rules runs for a 20-year period. The 20-year period generally starts from the date a CCC is issued for a self-contained residence (new build) added to the land, although some new builds have an alternative start date.

All owners of new build land during the 20-year period qualify for the exemption – this includes the initial owner and any subsequent purchasers within that period.

Alternative start date for some new builds

For some new builds, the exemption will not start from the date a CCC is issued for a new build on the land. Instead, the exemption will start from the date that construction of the new build was completed. The date of completion used is the date recorded in local authority or building consent authority records.

New build	Explanation	Section
New build was converted from a hotel or motel and no CCC is issued	Hotels/motels are already configured for short-term stays, so the work required to convert a hotel or motel into a place suitable for long-term residential rental accommodation may not always result in a CCC. This rule therefore ties the commencement of the exemption with the date local authority or building consent authority records show the conversion was completed.	DH 4(1)(b)(ii)
New build is a remediated earthquake prone building and no CCC is issued	Sometimes no CCC is issued after an earthquake prone building is remediated, but documentation is lodged with a local authority or building consent authority that shows the remediation has been completed and was verified by a suitably qualified engineer. This rule allows the new build exemption to apply in these cases. This is because records held by the authority ensure it is objectively verifiable that the building was previously on the earthquake prone buildings register but has since been removed.	DH 4(1)(b)(ii)
New build receives its CCC subject to a modification to clause B2.3.1 of the Building Code	There may be circumstances where the issuance of a CCC for a new build is significantly delayed, so it is issued subject to clause B2.3.1 of the Building Code. This rule helps ensure there is no tax benefit for a taxpayer who deliberately pushes out the date their new build receives its CCC. So, where a CCC is issued subject to B2.3.1 modification, the new build exemption applies from the earlier date that the new build was actually completed (as recorded by the	DH 4(1)(b)(iii)

New build	Explanation	Section
	relevant local authority or building consent authority), rather than the date the CCC was issued.	

Applies for 20 years

The new build exemption generally applies for 20 years (although there is an exception for new builds acquired off the plans, as discussed below). It starts from the date the land becomes new build land, and it ends once 20 years have passed since either:

- the date a CCC was issued for a new build on the land (section DH 4(1)(b)(i)), or
- the date the completion of the new build is recorded by a local authority or building consent authority (sections DH 4(1)(b)(ii) and (iii)).

Example 45: New build receives CCC

Penny acquires an already constructed townhouse in Petone that received its CCC on 24 October 2021 (which is before she acquired it). The new build exemption from the interest limitation rules will apply to interest incurred for the townhouse for 20 years from the date of the CCC. Penny will be able to deduct interest incurred for the townhouse from the date title for the land is registered to her, assuming the normal deductibility criteria are met.

Immediately after acquiring the townhouse, Penny rents the property out to Graham and Claire as a long-term residential rental property. Penny holds on to the property for the next thirty years and continues to use it as a long-term residential rental property during this period.

Since Penny is using the townhouse for an income-earning activity, she will be able to deduct interest for the townhouse while the exemption applies, which is until 23 October 2041. From 24 October 2041 onwards, Penny will not be able to deduct interest for the property. This is because the new build exemption will cease to apply, and she will be denied a deduction for the interest under the interest limitation rules.

Example 46: B2.3.1 modification rule

Rip owns a large section that has a residential rental property on one half of it. The rental was built on the land in the 1980s, so interest deductions are progressively denied from 1 October 2021 under the interest limitation rules. However, Rip decides to develop the other half of the section to add a new build to it. He claims interest deductions for the portion of the land he is developing under the development exemption.

The building work for the new build is substantially completed by 24 October 2021. Rip changes his mind about using the new build as a rental property, and he instead decides he wants to live in the new build as his main home, as it is modern and low maintenance. Rip thinks he is likely to sell the property at some point in the next ten years so deliberately holds off getting a CCC for the new build to maximise its potential value to a subsequent debt-financed purchaser. Eight years later, Rip decides he wants to sell the land. Rip gets in touch with his local council to request a CCC for the new build. The council issues a CCC for the new build on 24 October 2029 but issues it subject to a B2.3.1 modification. On the CCC, the substantial completion date for the new build is recorded as being 24 October 2021, which is the date the durability of the building is counted from (instead of the date the CCC was issued).

Since Rip's new build's CCC was issued subject to a B2.3.1 modification, the 20-year period for the new build exemption is counted from the date of substantial completion (24 October 2021), rather than the date the CCC for the new build was issued (24 October 2029). This means that Rip gains no tax advantage by delaying the CCC for his new build. The new build exemption ends on 23 October 2041, even though the CCC was not issued until 24 October 2029.

Example 47: Hotel units converted to new builds

Haydn owns a large hotel complex in Rotorua comprising 100 separate units. Ever since the borders closed because of the COVID-19 pandemic, the reduced number of tourists has meant that many of his units have sat empty or have only been booked a fraction of the time they were previously. He has heard there is a shortage of long-term rental accommodation in the region, so he decides to convert his units into places that can be let as long-term rentals instead.

Since the units were already configured for short-term stays by tourists, they have kitchens and bathrooms. Haydn engages tradespeople to do some work to ensure the units are more appropriately configured for use as long-term residential rental accommodation. The work Haydn has done to the property is not significant enough to require building consents, which means CCCs are not issued for the work.

Haydn gets in touch with his local authority (which is also a building consent authority) and notifies them that he has converted all his hotel units into residential accommodation. This conversion is noted down in the authority's records as having been completed on 24 October 2021. The new build exemption will apply to Haydn's units for 20 years from this date, so until 23 October 2041.

The 20-year fixed period is effectively attached to the land and does not reset when new build land is sold. This means that all owners of the new build land during the 20-year period would qualify for the exemption. This includes the initial owner and any subsequent purchasers within that period.

Example 48: Office block conversion with new builds sold within 20 years

Sandra owns an office block that she has decided to convert into ten apartments. She arranges for extensive building work to be done to convert the office space into individual apartments, including adding in bathrooms and kitchens for each unit. CCCs are issued on 24 October 2021 confirming that the building work to convert the office space into apartments is complete. The new build exemption from the interest limitation rules would apply to the apartments from 24 October 2021 until 23 October 2041.

Ten years later, on 24 October 2031, Sandra sells the apartment block because she is moving overseas. Sean acquires the apartment block and keeps it for five years. On 24 October 2036, Sean sells the apartment block to Josh. Josh holds the apartment block for fifteen years.

The apartments are always rented out for the period covered by this example.

Sandra and Sean can deduct interest for the apartment block for the entire period they own the apartments (from 24 October 2021 to 23 October 2031 for Sandra, and from 24 October 2031 to 23 October 2036 for Sean). This is because the new build exemption applies.

Josh can deduct interest from 24 October 2036 to 23 October 2041. The new build exemption ends on 23 October 2041, 20 years after the apartments received their CCCs. Josh will be denied interest deductions from 24 October 2041 onwards under the interest limitation rules.

Relevance of the residential rental loss ring-fencing rules

No changes have been made to the residential rental loss ring-fencing rules. This means these rules continue to apply as they currently do to interest deductions incurred in relation to rental properties.

Grandparented residential interest

Sections DH 5(5), DH 7, DH 8(1), (2) and DH 9 of the Income Tax Act 2007

Grandparented residential interest is interest incurred on the principal of a grandparented transitional loan. Deductions for grandparented residential interest are progressively denied from 1 October 2021 to 31 March 2025. From 1 April 2025, no deductions are allowed. A grandparented transitional loan is, in general terms, a loan for disallowed residential property (DRP) first drawn down before 27 March 2021, although exceptions exist for DRP acquired near the March 2021 announcement date and for refinanced loans.

Inland Revenue has a phasing calculator on its website that can be used by taxpayers to calculate the progressive denial of grandparented residential interest deductions. The calculator is at: https://www.ird.govt.nz/property/renting-out-residential-property.

Key features

Grandparented residential interest is interest incurred on the principal of a grandparented transitional loan to the extent to which it is incurred for DRP. Grandparented transitional loans are New Zealand dollar denominated loans for DRP first drawn down before 27 March 2021, although some exceptions exist for DRP acquired near the March 2021 announcement date and for refinanced loans. Deductions for grandparented residential interest are progressively denied at specified percentages for specified periods from 1 October 2021 to 31 March 2025. From 1 April 2025, no deductions for grandparented residential interest are allowed.

The progressive denial of grandparented residential interest deductions from 1 October 2021 to 31 March 2025 is to mitigate the cashflow impacts of the interest limitation rules on taxpayers who debt funded the purchase of DRP before the announcement of the rules and to allow these taxpayers time to adjust to the rules. The portion of the interest that is not denied a deduction under the interest limitation rules remains deductible, provided the other requirements in the Income Tax Act for deductibility are satisfied (for example, a nexus with income).

Application date

The new provisions came into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Detailed analysis

Progressive denial of grandparented residential interest

Section DH 8(1)(b) provides taxpayers are denied a deduction for interest if and to the extent to which it is grandparented residential interest.

Section DH 8(2) provides that, for specified periods from 1 October 2021 to 31 March 2025, the amount of the deduction for grandparented residential interest that is denied (under section DH 8(1)) is limited to specified percentages. The percentage of deduction denied in each of the specified periods is set out in the table below. From 1 April 2025, no deductions for grandparented residential interest are allowed (that is, grandparented residential interest will be treated the same as other interest incurred for DRP).

Period that grandparented residential interest is incurred	Percentage denied
1 October 2021 to 31 March 2022	25%
1 April 2022 to 31 March 2023	25%
1 April 2023 to 31 March 2024	50%
1 April 2024 to 31 March 2025	75%
On and after 1 April 2025	100%

The periods in the table above apply regardless of a taxpayer's balance date. Taxpayers who do not have a 31 March balance date may have to apply different percentages to the grandparented residential interest incurred within their income year, depending on whether the interest was incurred before or after 31 March. For example, a taxpayer working out how much grandparented residential interest is denied a deduction in their income year ended 30 September 2023 would add the following two amounts:

- twenty-five percent of the grandparented residential interest incurred between 1 October 2022 and 31 March 2023, and
- fifty percent of the grandparented residential interest incurred between 1 April 2023 and 30 September 2023.

Up to 31 March 2025, the portion of interest that is not denied under section DH 8 remains deductible, provided the other requirements for deductibility are satisfied. This will generally include satisfying the general permission in section DA 1 and ensuring none of the general limitations in section DA 2 apply.

Grandparented residential interest

"Grandparented residential interest" is defined in section DH 7 as interest on the principal of a "grandparented transitional loan" to the extent to which the interest is incurred for DRP.

Example 49: Grandparented residential interest

Joe took out an interest-only loan to acquire a DRP in 2017. As at 26 March 2021, the balance of Joe's loan is $500,000 and the interest rate is 4.0% pa. Joe does not make any principal repayments on the loan.

The loan would be a grandparented transitional loan and the grandparenting rules would apply to Joe as follows:

- From 1 April 2021 to 30 September 2021, Joe incurs interest expenditure of $10,000, which is fully deductible.
- From 1 October 2021 to 31 March 2022, Joe incurs interest expenditure of $10,000, but 25% of this amount ($2,500) is denied. $7,500 of the interest incurred may be deductible, subject to satisfying the deductibility tests.
- From 1 April 2022 to 31 March 2023, Joe incurs interest expenditure of $20,000, but 25% of this amount ($5,000) is denied. $15,000 of the interest incurred may be deductible, subject to satisfying the deductibility tests.
- From 1 April 2023 to 31 March 2024, Joe incurs interest expenditure of $20,000, but 50% of this amount ($10,000) is denied. $10,000 of the interest incurred may be deductible, subject to satisfying the deductibility tests.
- From 1 April 2024 to 31 March 2025, Joe incurs interest expenditure of $20,000, but 75% of this amount ($15,000) is denied. $5,000 of the interest incurred may be deductible, subject to satisfying the deductibility tests.

From 1 April 2025 onwards, Joe would not be allowed any deductions for interest under his loan.

In some cases, a grandparented transitional loan may have been used for both DRP and for allowed property (for example, a commercial rental property), and it may be very difficult, or even impossible, to determine (trace) the portion of the loan used for DRP. The rules that apply in such a situation to identify the amount of grandparented residential interest are discussed in the "Grandparented transitional loans that cannot reasonably be traced" section of this special report.

Grandparented transitional loans

The term "grandparented transitional loan" is defined in section DH 5(5) as loan amounts denominated in New Zealand dollars to the extent to which they are described in one of paragraphs (a) to (f). Loan amounts do not include re-drawings or additional borrowings under the same facility on or after 27 March 2021.[23]

Thus, loan amounts are a grandparented transitional loan to the extent to which the loan amounts satisfy one of the following paragraphs of section DH 5(5).

General rule (paragraph (a))

Section DH 5(5)(a) provides for loan amounts first drawn down before 27 March 2021 for DRP.

Property acquired before 27 March 2021 (paragraph (b))

Section DH 5(5)(b) provides for loan amounts first drawn down on or after 27 March 2021 to acquire DRP if an estate or interest in the DRP was acquired before 27 March 2021.

Section DH 5(5)(b) will apply where a taxpayer entered into a binding agreement for sale and purchase before 27 March 2021, but settlement and the drawing down of the loan to fund the settlement did not occur until on or after 27 March 2021. Interest incurred on such a loan is grandparented residential interest.

Example 50: Grandparented transitional loan – settlement on or after 27 March 2021

Petra entered into a binding sale and purchase agreement to acquire a property in February 2021. Settlement did not take place until April 2021, when she drew down a $400,000 loan to complete the purchase. The $400,000 loan would be a grandparented transitional loan under section DH 5(5)(b).

Petra's interest on her loan is $1,000 per month, and it would qualify as grandparented residential interest.

- Between 1 October 2021 and 31 March 2023, $250 of her monthly interest expense would be denied. The remaining $750 may be deductible, subject to satisfying the deductibility tests.
- Between 1 April 2023 and 31 March 2024, $500 of her monthly interest expense would be denied. $500 per month may be deductible, subject to satisfying the deductibility tests.

[23] An exception to this is the high water mark rules: see the "High water mark" section of this special report.

- Between 1 April 2024 and 31 March 2025, $750 of her monthly interest expense would be denied. $250 per month may be deductible, subject to satisfying the deductibility tests.

From 1 April 2025, Petra would not be able to claim any interest deduction.

Example 51: Additional borrowings

Assume the same facts as in example 50 above but, in May 2021, Petra drew down an additional $100,000 to add an extra floor onto the same property. Interest on this $100,000 is $250 per month.

The additional $100,000 was not part of the loan required to complete the sale and purchase agreement signed before 27 March 2021 to acquire the DRP. Therefore, it does not qualify as a grandparented transitional loan (or part of such a loan). From 1 October 2021, Petra cannot claim any deduction for the $250 per month interest expense incurred on the additional $100,000.

For tax purposes, a property is generally acquired on the date a binding sale and purchase agreement is entered (even if some conditions still need to be met). Further information on when a property is acquired can be found in QB 17/02.[24]

Irrevocable offers made on or before 23 March 2021 (paragraph (c))

Section DH 5(5)(c) provides for loan amounts first drawn on or after 27 March 2021 for acquiring DRP if the acquisition is the result of an offer:

- made on or before 23 March 2021, and
- that could not be revoked by the purchaser taxpayer before 27 March 2021.

Irrevocable offers are common when sale is by tender. Prospective purchasers are required to make irrevocable offers for a property by a certain date, with the vendor accepting an offer after that date. Section DH 5(5)(c) only applies to offers made on or before 23 March 2021, which is the date the interest limitation rules were announced. Taxpayers who made an offer to purchase DRP on or before 23 March 2021 that was irrevocable before 27 March 2021

[24] QB 17/02: Income tax – date of acquisition of land, and start date for 2-year bright-line test. https://www.taxtechnical.ird.govt.nz/en/questions-we-ve-been-asked/2017/qb-1702-income-tax-date-of-acquisition-of-land-and-start-date-for-2-year-bright-line-test

were legally committed to purchase the DRP if their offer was accepted, even if they did not acquire the DRP before 27 March 2021. These taxpayers are in a similar position to taxpayers who purchased DRP before 27 March 2021 and for that reason they can apply the grandparenting rules.

Example 52: Grandparented transitional loan – irrevocable offer

Ted made an offer to purchase a property through a tender process that closed on 22 March 2021, but the offer was not accepted until 27 March 2021. The terms of the tender stated that he could not withdraw the offer until 28 March 2021.

Ted would meet the requirements of section DH 5(5)(c) and his loan to acquire the property would be a grandparented transitional loan. This is the case even though he did not acquire the property before 27 March 2021, as would be required under section DH 5(5)(b).

Rollover relief (paragraph (d))

Section DH 5(5)(d) provides for loan amounts for DRP acquired on or after 27 March 2021 by a taxpayer if three requirements relating to rollover relief for the bright-line test are satisfied. The first requirement is that a previous owner of the DRP (the original owner) had loan amounts described in one of paragraphs (a) to (c). The second requirement is that every transfer of the DRP from the original owner to (any and every intermediate owner and then to) the taxpayer has been a transfer to which a specified bright-line rollover provision has applied. The third requirement is that the loan amounts of the taxpayer are equal to or less than the amount of the original owner's loan at the time the original owner transferred the DRP.

Section DH 5(5)(d) is discussed in detail in the "Rollover relief – transfer of disallowed residential property" section of this special report.

Refinancing (paragraphs (e) and (f))

Section DH 5(5)(e) provides for loan amounts drawn down on or after 27 March 2021 that refinance a grandparented transitional loan described in any of paragraphs (a) to (d). If a foreign currency loan that would have been a grandparented transitional loan if it had been denominated in New Zealand dollars is refinanced by a loan in New Zealand dollars drawn down after 27 March 2021, that New Zealand dollar loan will be a grandparented transitional loan under section DH 5(5)(f).

Foreign currency loans

Section DH 5(5) provides that grandparented transitional loans must be denominated in New Zealand dollars. Section DH 9 also excludes a foreign currency loan from the progressive denial of grandparented residential interest under section DH 8(2). "Interest" for income tax purposes includes amounts calculated under the financial arrangements rules.[25]

For a foreign currency loan, income and expenditure under the financial arrangements rules includes foreign exchange gains and losses, which can fluctuate from year to year. These fluctuations would make the calculation of grandparented residential interest for a foreign currency loan extremely complex, and for this reason, a deduction for interest for a foreign currency loan is fully denied from 1 October 2021.

Section DH 5(5)(f), however, provides that where a foreign currency loan that would have been a grandparented transitional loan if it had been denominated in New Zealand dollars is refinanced in New Zealand dollars, the refinanced loan is a grandparented transitional loan from the time the refinanced loan is first drawn down.

Change in use from main home to DRP

As mentioned above, a grandparented transitional loan is, in general terms, a loan for DRP first drawn down before 27 March 2021. Grandparented residential interest is interest incurred on a grandparented transitional loan and deductions for such interest are progressively denied from 1 October 2021 to 31 March 2025.

As discussed under the "*Change in use during income year*" heading in the "Definition of disallowed residential property" section of this special report, if a person takes out a loan for a main home and the person subsequently moves out and rents that property to tenants, the loan will change from being for excepted residential land (in this case, a main home) to being for DRP. If the loan was drawn down before 27 March 2021 (or it falls within one of the exceptions for property acquired near announcement date and for refinanced loans), the loan will be a grandparented transitional loan for the period the property is DRP. Interest incurred on the loan while it is a grandparented transitional loan will therefore be grandparented residential interest and subject to progressive denial from 1 October 2021 to 31 March 2025.

[25] See paragraph (c) of the definition of "interest" in section YA 1 of the Income Tax Act 2007.

Example 53: Change in use from main home to DRP

Katie acquired her main home in 2017 using mortgage finance. She lives in it until she permanently moves to a different city for a new job at the end of September 2022. She earns rental income from renting out her property from 1 October 2022.

Katie incurs $1,250 interest each month on her mortgage, or $7,500 every 6 months. Katie has a standard balance date, ending 31 March.

The interest limitation rules do not apply to Katie for the 2021–22 income year as the property was her main home for the full year. The rules also do not apply for the first six months of the 2022–23 income year (1 April 2022 to 30 September 2022) for the same reason. However, she cannot claim an interest deduction because she did not earn any income from her main home.

However, from 1 October 2022, Katie's loan is no longer for excepted residential land (her main home) and is now for DRP. As the loan was drawn down before 27 March 2021, the loan is now a grandparented transitional loan. Assuming the other tests for deductibility are met:

- For the 2022–23 income year, Katie can claim a deduction for $5,625 interest (being 75% of the $7,500 interest incurred for the 6-month period from 1 October 2022 to 31 March 2023).
- For the 2023–24 income year, she can claim a deduction for $7,500 interest (50% of $15,000).
- For the 2024–25 income year, she can claim a deduction for $3,750 (25% of $15,000).
- From the 2025–26 income year onwards, Katie is no longer able to claim any deduction for interest.

Grandparented transitional loans that cannot reasonably be traced

Sections DH 5(5), DH 7, DH 8(1), (2) and DH 12 of the Income Tax Act 2007

Generally, interest is denied under the interest limitation rules in subpart DH if it is incurred for disallowed residential property (DRP). Taxpayers must apply existing general tracing principles used in other parts of the Income Tax Act to determine if interest is incurred for DRP.

A "grandparented transitional loan" is generally[26] a loan drawn down before 27 March 2021 that has been used for DRP. Interest incurred on a grandparented transitional loan is "grandparented residential interest", and deductions for grandparented residential interest are progressively denied from 1 October 2021 to 31 March 2025.[27]

In some cases, a grandparented transitional loan may have been used for both DRP and allowed property (for example, a commercial rental property). It may be difficult, or even impossible, to trace such a loan and determine how much of the loan proceeds were used for DRP. In that case, the transitional rule in section DH 7 treats a portion of the grandparented transitional loan as having been used to acquire DRP. Only interest incurred on that portion is grandparented residential interest and progressively denied a deduction. The remaining portion of the grandparented transitional loan is not subject to limitation under subpart DH.

Section DH 7 also contains a rule that specifies how repayments of the grandparented transitional loan are treated.

Key features

When a grandparented transitional loan was used for both DRP and allowed property, and the portion of the loan incurred for DRP cannot reasonably be determined, the transitional rule in section DH 7 applies. Whether the portion incurred for DRP cannot reasonably be determined will be a question of fact and degree in each case.

In effect, section DH 7 treats a grandparented transitional loan that cannot reasonably be traced (an untraceable loan) as being used to acquire allowed property before being used to acquire DRP. This is done based on the value of allowed property held by the relevant taxpayer on 26 March 2021. Allowed property is:

- property that gives rise to assessable income and is not DRP, and
- DRP subject to an exemption in section DH 4.

If the balance of an untraceable loan is less than the value of allowed property held on 26 March 2021, none of the interest on the loan is subject to limitation under subpart DH.

[26] There are some exceptions, such as loans for property acquired around the March 2021 announcement date and refinanced loans.
[27] See the "Grandparented residential interest" section of this special report.

If the balance of the untraceable loan exceeds the value of allowed property held on 26 March 2021, the excess is "notional loan principal" and is treated as having been used to acquire DRP. Interest on the notional loan principal is treated as grandparented residential interest and is denied a deduction under section DH 8 on a progressive basis between 1 October 2021 and 31 March 2025.

Section DH 7 also contains rules that specify how repayments of an untraceable loan are to be treated. Generally, repayments are applied to the notional loan principal first, unless the repayment is funded from the disposal of allowed property held on 26 March 2021.

Application date

The new provisions came into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Detailed analysis

Grandparented transitional loans and grandparented residential interest

The term "grandparented transitional loan" is defined in section DH 5(5). It is generally a loan drawn down before 27 March 2021 to the extent to which it has been used for DRP.

New section DH 8(1)(a) denies a deduction for interest incurred for DRP, excluding interest for a grandparented transitional loan.

New section DH 8(1)(b) denies a deduction for grandparented residential interest, being interest on a grandparented transitional loan to the extent it is for DRP.

Interest incurred for a grandparented transitional loan is excluded from section DH 8(1)(a) and dealt with in section DH 8(1)(b) because a grandparented transitional loan may have been used for both DRP and other allowed property. For such a mixed-use loan, it is necessary to identify the portion of the loan that is for DRP, as the interest limitation rules will apply only to the interest on that portion (grandparented residential interest). Interest on the remaining portion is not subject to limitation under subpart DH. Whether a deduction is allowed for the interest incurred on the remaining portion is determined under the other rules in Part D.

"Grandparented residential interest" is defined in new section DH 7. In the context of an untraceable loan, it means the portion of interest calculated by reference to a notional loan principal that the person is treated as having used to acquire, on 26 March 2021, the DRP to which the loan relates.

Untraceable loans

An untraceable loan is a grandparented transitional loan used for both DRP and allowed property where the portion of the loan used for DRP cannot reasonably be determined. An untraceable loan is referred to in the legislation as "the underlying loan".

Subpart DH does not specify the circumstances in which the portion of a grandparented transitional loan used for DRP cannot reasonably be determined. It will be a question of fact and degree in each case.

Factors relevant to whether the portion of a grandparented transitional loan used for DRP cannot reasonably be determined may include:

- Whether the necessary information is in the possession of the taxpayer.
- If the necessary information is not in the possession of the taxpayer, whether the taxpayer can reasonably obtain the information (including from a third party, if necessary).

If a taxpayer needs to obtain information from a third party to determine the portion of a grandparented transitional loan incurred for DRP and the third party charges the taxpayer for the information, the fact the third party charges for the information would not in itself mean that the portion of the loan used for DRP cannot reasonably be determined.

Notional loan principal

A taxpayer with an untraceable loan must apply the formula in section DH 7(2) to determine their "notional loan principal". The notional loan principal is the portion of the underlying loan that the person is treated as having used to acquire DRP on 26 March 2021.

The formula is:

$$\text{outstanding borrowings} - \text{allowed property}$$

The items in the formula are defined in section DH 7(3):

- **Outstanding borrowings** is the principal of the grandparented transitional loan (the underlying loan) on 26 March 2021, to the extent it is used for both DRP and allowed property.

- **Allowed property** is the total of the taxpayer's property on 26 March 2021, ignoring property that is not used in deriving assessable income and only including DRP if it is subject to an exemption in section DH 4. The value of "allowed property" as at 26 March 2021 is determined using the valuation rules in section DH 12.

To the extent the principal of the underlying loan is not for DRP or allowed property it is excluded from "outstanding borrowings". For example, if a loan drawn down before 27 March 2021 was used for DRP, allowed property and private purposes, the portion used for private purposes will not form part of the "outstanding borrowings" under section DH 7(3)(a). This ensures the formula only applies to borrowings for which interest expenses were deductible for tax purposes before 1 October 2021.

Section DH 7(2) provides that if the formula results in a negative amount, the amount is treated as zero. When the amount is zero, there is no notional loan principal and no amount of grandparented residential interest. As a result, section DH 8(1)(b), which denies a deduction for grandparented residential interest, cannot apply. Consequently, subpart DH will not apply to any interest incurred on the grandparented transitional loan.

Example 54: No notional loan principal

On 26 March 2021, Tiffany owns two properties that she uses to earn taxable rental income. Both properties were acquired at around the same time in the 1990s. They are:

- a DRP, purchased for $300,000, with a current capital value of $900,000, and
- a commercial rental property, purchased for $400,000, with a current capital value of $850,000.

She acquired the two properties using a combination of loans and savings. Over the years, Tiffany has refinanced and restructured her loans several times and has made many repayments. On 26 March 2021, she has a single grandparented transitional loan of $200,000 and no other debt.

Although Tiffany never used her loan for personal purposes, she did not trace exactly how the borrowed funds were applied to each property in the past and does not have the records to do so now.

Applying the formula in section DH 7(2), outstanding borrowings less allowed property is:

$$\$200{,}000 - \$850{,}000 = -\$650{,}000$$

As the amount is a negative number, it is treated as zero. Therefore, Tiffany would not have a notional loan principal under section DH 7(2) and none of the interest incurred under her grandparented transitional loan would be grandparented residential interest. The interest under her grandparented transitional loan would therefore not be subject to limitation under subpart DH, and Tiffany can continue to deduct all her interest expenditure under the loan indefinitely.

Repayments

When a taxpayer with an untraceable loan has a notional loan principal, the taxpayer is, in effect, treated as having two loans – the notional loan principal, which is treated as having been used for DRP, and the remaining loan portion, which is treated as having been used for allowed property.

When a repayment is made reducing the balance of an untraceable loan, it is necessary to allocate the repayment to the reduction of either the loan for allowed property or the notional loan principal.

Section DH 7(4) specifies how repayments of an untraceable loan are to be allocated.

General repayments rule

The general rule is that repayments are applied against the notional loan principal until it is reduced to zero. When the notional loan principal is reduced to zero, there will be no grandparented residential interest (and the interest limitation rules will no longer apply to the untraceable loan).

Example 55: General rule for repayments

Sanjay earns income from rental properties. On 26 March 2021, Sanjay owns the following assets that he uses to earn taxable rental income:

- a DRP in Christchurch, with a current capital value of $500,000
- a commercial rental property in Ashburton, with a current capital value of $400,000, and
- a commercial rental property in Timaru, with a current capital value of $200,000.

Sanjay's assets were acquired many years ago using a combination of loans and savings. On 26 March 2021, he has one outstanding interest-only loan of $800,000 and no other debt.

Sanjay has always been careful never to use his borrowings for personal purposes, but he did not trace how the borrowed funds were applied in the past and does not have the records to do so now.

<u>For the income year ended 31 March 2022</u>

From 1 April 2021 to 30 September 2021, Sanjay's interest expenditure under his loan totals $18,000.

From 1 October 2021 to 31 March 2022, Sanjay's interest expenditure under his loan totals $20,000.

Sanjay's $18,000 interest expenditure incurred before 1 October 2021 is not affected by the new interest limitation rules and remains fully deductible. For the remaining $20,000 interest expenditure incurred after 1 October 2021, Sanjay has to apply the rules in section DH 7.

Applying the formula in section DH 7(2), Sanjay's outstanding borrowings less allowed property is:

$800,000 – ($400,000 + $200,000) = $200,000

Sanjay's notional loan principal is therefore $200,000. Interest on $200,000 of Sanjay's loan is grandparented residential interest. Interest on the remaining loan portion of $600,000 is not subject to limitation under subpart DH.

To work out his grandparented residential interest, Sanjay has to divide his notional loan principal by his total outstanding borrowings and multiply the result by his interest under the loan:

200,000/800,000 x $20,000 = $5,000 of grandparented residential interest

The amount of interest denied a deduction under section DH 8(2) is therefore $1,250 ($5,000 x 25%).

For the income year ended 31 March 2023

Sanjay receives an inheritance, and he uses it to make a lump sum repayment of $100,000 on his loan on 1 April 2022. His total interest expenditure incurred under the loan for the income year is $30,000.

Sanjay's loan balance on 31 March 2023 is $700,000.

Applying the general repayments rule, the reduction in the loan balance is applied against his notional loan principal. Therefore, Sanjay's notional loan principal is reduced from $200,000 to $100,000. The amount that is grandparented residential interest for the income year is calculated as follows:

100,000/700,000 x $30,000 = $4,286

The amount of interest denied a deduction under section DH 8(2) is therefore $1,071 ($4,286 x 25%).

General repayments rule overridden

The general repayments rule is overridden if the source of the repayment is the disposal of allowed property that was held on 26 March 2021. If the source of the repayment is the disposal of allowed property, only the amount of the repayment that exceeds the 26 March 2021 value of the allowed property is applied against the notional loan principal to reduce it. If the amount of the repayment is less than or equal to the 26 March 2021 value of the allowed property, the repayment does not reduce the notional loan principal.

Example 56: Repayments from sale of allowed property

Assume the same facts as in example 55, but instead of receiving an inheritance, Sanjay sells his Timaru property for $200,000 and uses the proceeds to make the $100,000 lump sum repayment. He uses the remaining $100,000 from the sale proceeds to pay for repairs and improvements to his Ashburton property.

For the income year ended 31 March 2023

Sanjay's loan balance on 31 March 2023 is $700,000 and his total interest expenditure under the loan for the income year is $30,000.

As the source of the repayment was the disposal of allowed property held on 26 March 2021, and the amount of the repayment is less than the value of the Timaru property on 26 March 2021, Sanjay's notional loan principal is unchanged from $200,000.

The amount that is grandparented residential interest is calculated as follows:

$$200{,}000/700{,}000 \times \$30{,}000 = \$8{,}571$$

The amount of interest denied a deduction under section DH 8(2) is therefore $2,143 ($8,571 x 25%).

Existing law on tracing applies to changes of use on or after 27 March 2021

Under existing law on the tracing of funds, where funds have been borrowed and the use of the borrowed funds changes, the deductibility of interest on those funds may also change as the funds are "traced" to a new use. For example, if a taxpayer borrows to acquire a van for their business, interest on their borrowings will be deductible. If they sell the van and use the sale proceeds to go on holiday, interest on the borrowings will become non-deductible.

As explained above, section DH 7 may treat a single loan as being either partly for DRP and partly for allowed property, or entirely for allowed property. Existing law on tracing applies if the DRP or allowed property held on 26 March 2021 is disposed of and the proceeds are applied to new uses.

Example 57: Disposal of allowed property held on 26 March 2021

LandCo is a close company that earns income from residential and commercial rental properties. On 26 March 2021, LandCo holds the following:

- a DRP, with a current capital value of $500,000
- a commercial rental property, with a current capital value of $500,000, and
- an untraceable interest-only loan of $600,000 at 4% pa.

For the income year ended 31 March 2022

From 1 April 2021 to 30 September 2021, LandCo's interest expenditure totals $12,000.

From 1 October 2021 to 31 March 2022, LandCo's interest expenditure totals $12,000.

LandCo's $12,000 interest expenditure incurred before 1 October 2021 is not affected by the interest limitation rules and remains fully deductible. For the remaining $12,000 interest expenditure incurred after 1 October 2021, LandCo has to apply the rules in section DH 7.

Applying the formula in section DH 7(2), LandCo's outstanding borrowings less allowed property is:

$600,000 – $500,000 = $100,000

LandCo's notional loan principal is therefore $100,000. Interest on $100,000 of LandCo's loan is grandparented residential interest. Interest on the remaining loan portion of $500,000 is not subject to limitation under subpart DH.

To work out its grandparented residential interest, LandCo has to divide its notional loan principal by its total outstanding borrowings and multiply the result by its interest under the loan:

100,000/600,000 x $12,000 = $2,000 of grandparented residential interest

The amount of interest denied a deduction under section DH 8(2) is therefore $500 ($2,000 x 25%).

<u>For the income year ended 31 March 2023</u>

On 1 April 2022, LandCo sells the commercial rental property for $500,000 and uses all of the proceeds to acquire an old-build DRP. Under existing tracing principles, interest on the $500,000 loan portion is fully denied under section DH 8(1). Interest on the $100,000 notional loan principal remains grandparented residential interest.

High water mark

Section DH 5(5), DH 7, DH 8(2) and DH 10 of the Income Tax Act 2007

The high water mark simplifies the calculation of grandparented residential interest for taxpayers with variable balance loans.

Key features

The high water mark is a transitional rule to simplify the calculation of grandparented residential interest[28] for taxpayers with variable balance loans (such as a revolving credit facility or an overdraft). Under this transitional rule, taxpayers with such loans are not required to trace each individual withdrawal and deposit to that loan account between 27 March 2021 and 31 March 2025.

A taxpayer who has used a variable balance loan for disallowed residential property (DRP) can treat this loan as a grandparented transitional loan while the balance of the loan (the affected loan balance) remains less than or equal to the initial loan balance on 26 March 2021. The interest on this grandparented transitional loan is grandparented residential interest and continues to be partially deductible during the transitional period under section DH 8(2). If the affected loan balance is higher than the initial loan balance on 26 March 2021, only interest on the initial loan balance is grandparented residential interest.

Application date

The new provisions came into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Background

Before the introduction of the interest limitation rules, a variable balance loan could result in declining interest deductions over time if the loan was used to finance a mixture of taxable and private activities. However, if a variable balance loan was used to finance only taxable activity, such as owning a residential rental property, this provided the taxpayer with flexibility in their funding while ensuring all interest was deductible.

Without section DH 10, a variable balance loan that finances DRP under the interest limitation rules could result in the amount treated as a grandparented transitional loan declining faster than the underlying loan balance. This is because each loan payment (such as a deposit of rent received) would reduce the amount of the grandparented transitional loan, while each drawdown (such as a regular interest charge) would be treated as new borrowing that did not qualify as a grandparented transitional loan. This would mean that the amount of grandparented residential interest could also reduce even if the balance of the loan, and the interest charged on that loan, remained constant.

[28] For more on this, see the "Grandparented residential interest" section of this special report.

Detailed analysis

Application

Although the high water mark in section DH 10 is designed to apply to variable balance loans (such as a revolving credit facility or an overdraft), the application provision in section DH 10(1) does not include this restriction. This is to prevent the need to define the boundary of what is a variable balance loan. For loans that do not have a variable balance, such as table loans or interest-only loans, section DH 10 will not have any practical effect as the balance would not increase above that owed on 26 March 2021. The provision specifically provides that it only applies to those who choose to rely on it.

What interest can be grandparented residential interest

Section DH 10(3) provides that a person's grandparented residential interest (that is, the amount of interest incurred on the loan that is denied under section DH 8(2) on a progressive basis between 1 October 2021 and 31 March 2025) is calculated based on the lower of:

- the initial loan balance on the date grandparented residential interest is first calculated (usually 26 March 2021, but see below), and
- the amount of their loan that is for DRP (the affected loan balance).

A person with a variable balance loan that has been applied solely to DRP is able to treat all interest as grandparented residential interest provided their affected loan balance remains at or below their initial loan balance. For a person who has also applied the loan for other purposes (for example, on a deductible purpose, such as a new build or commercial property, or on private expenditure) or who has increased the affected loan balance above the initial loan balance, the calculation of grandparented residential interest is still simpler and results in a higher amount of such interest than if section DH 10 was not available.

Initial loan balance

For most taxpayers, the initial loan balance is the balance of their grandparented transitional loan at the end of 26 March 2021: section DH 10(4)(a).

For taxpayers who borrowed on or after 27 March 2021 to acquire a DRP where the loan amount meets paragraph (b) or (c) of the definition of a "grandparented transitional loan" in section DH 5(5), the initial loan balance is set on the date the loan is drawn down: section DH 10(4)(b).

For taxpayers who transfer DRP under section FC 9B(a) to (f), which relate to certain family trusts, Treaty of Waitangi settlements, look-through companies and partnerships, the initial loan balance is set on the date of the transfer: section DH 10(4)(c).

Example 58: Initial loan balance

On 26 March 2021, Davy owes $500,000 on a revolving credit facility that is mostly used to fund his residential rental property. However, on 10 March 2021, Davy withdrew $20,000 to buy a car he uses privately. The revolving credit facility has a limit of $600,000.

Davy's initial loan balance is the portion of the facility allocated to DRP, which is $500,000 - $20,000 = $480,000.

Affected loan balance

The affected loan balance is the actual loan balance of the taxpayer's grandparented transitional loan at any particular time. Under section DH 10(5), this amount is calculated by making adjustments for further amounts borrowed and repaid under the loan after the date of the initial loan balance. These adjustments ensure the amount that has been spent on a grandparented transitional loan can be determined and compared against the initial loan balance.

The formula for calculating the affected loan balance is:

initial loan balance + (advances – repayments) – (unrelated advances – unrelated repayments)

where:

- **initial loan balance** is the amount calculated under section DH 10(4), as explained above
- **advances** and **repayments** are all debit and credit entries relating to that loan between 27 March 2021 and the date the affected loan balance is calculated. For a person who had applied their loan only to DRP as at 26 March 2021, the total of "initial loan balance + (advances – repayments)" will be equal to the balance of that loan account
- **unrelated advances** are any withdrawals from the loan that are applied to something other than a grandparented transitional loan – this could include, for example, another DRP purchased on or after 27 March, a taxable activity including property

that qualified as a new build, or private expenditure. Unrelated advances also include any interest charged on the loan that was apportioned to something other than the property funded by the grandparented transitional loan.

- **unrelated repayments** can only arise for taxpayers who have grandparented transitional loans that cannot be traced under section DH 7(1)(b), meaning there is an initial notional loan principal under section DH 7(2) [29]. Unrelated repayments are the portion of a repayment that is not allocated to the notional loan principal under section DH 7(4). This circumstance arises only where a portion of the loan is repaid and that repayment fully repays the portion allocated to the notional loan principal, that is, the amount outstanding is now less than the value of the property funded by the grandparented transitional loan.

Example 59: Affected loan balance remains below initial loan balance

On 26 March 2021, Darryl owes $500,000 on a revolving credit facility used to fund his residential rental property. The revolving credit facility has a limit of $600,000. Darryl does not use this account to fund any private expense or for any other deductible uses. His initial loan balance is therefore $500,000.

When Darryl completes his tax return for the year ended 31 March 2022, he must calculate the affected loan balance for each day between 1 October 2021 and 31 March 2022. As he has only used the revolving credit facility for a rental property acquired before 27 March 2021, the advances and repayments items of the formula are the same as the withdrawals and repayments shown on his internet banking. He has not made any unrelated advances or unrelated repayments so both these items are zero.

In his bank statement, Darryl sees that the balance of the revolving credit facility on 1 October 2021 was $480,000, which is the affected loan balance on that date. He also sees that between 1 October 2021 and 31 March 2022 the balance of the revolving credit facility was always below $500,000.

As the affected loan balance was always below the initial loan balance, 75% of the interest charged on the revolving credit facility during 1 October 2021 to 31 March 2022 can be deducted as grandparented residential interest after applying section DH 8(2).

[29] For more on this, see the "Grandparented transitional loans that cannot reasonably be traced" section of this special report.

Sections DH 10(3) and (5) refer to the loan balance at an instant. Typically, lenders will calculate interest based on the outstanding balance at the end of each day even though that charge will be applied over a longer period (for example, fortnightly or monthly). Where there is more than one transaction on an account within this interest calculation period, these will often be able to be aggregated (for example, if money is deposited into an account and withdrawn the same day, the net effect will be zero).

If the affected loan balance was above the initial loan balance for only part of a year, it is intended that separate grandparented residential interest calculations would be completed for each of these periods to arrive at a single grandparented residential interest calculation for the year. As a lender is unlikely to provide a breakdown of interest charged on a daily basis, a taxpayer in this situation would be required to breakdown their interest calculations beyond that provided by their lender. While this adds complexity, it is an unavoidable consequence of the overall approach. A taxpayer who keeps their affected loan balance below their initial loan balance will not face this complication.

Example 60: Affected loan balance briefly goes above initial loan balance

On 26 March 2021, Nicola owes $500,000 on a revolving credit facility used to fund her residential rental property. The revolving credit facility has a limit of $600,000. Nicola does not use this account to fund any private expense or for any other deductible uses. Her initial loan balance is therefore $500,000.

When Nicola completes her tax return for the year ended 31 March 2022, she must calculate the affected loan balance for each day between 1 October 2021 and 31 March 2022. As she has only used the revolving credit facility for a rental property acquired before 27 March 2021, the advances and repayments items of the formula are the same as the withdrawals and repayments shown on her internet banking. She has not made any unrelated advances or unrelated repayments so both these items are zero.

In her bank statement, Nicola sees that the balance of the revolving credit facility on 1 October 2021 was $490,000, which is the affected loan balance on that date. She also sees a withdrawal on 15 December 2021 took the balance above the initial loan balance to $506,000, and the balance did not return below the initial loan balance until a deposit of $10,000 was made on 24 December 2021. For the remainder of the period, until 31 March 2022, the balance remained below $500,000.

On 31 December Nicola's bank charged her $1,700 in interest for the December month. Nicola calculates the non-deductible interest as the portion of the affected loan balance that was above the initial loan balance ($6,000 x 9 days x interest rate). Of the remainder of the $1,700 interest charge for the month, 75% can be deducted as grandparented residential interest after applying section DH 8(2).

A detailed example of the intended calculation of the affected loan balance is included in example 63 below. This example shows the effect (excluding adjustments for interest) when a single loan has been applied for a mixture of DRP, fully deductible activities and private purposes. If a variable balance loan is only applied for DRP, no adjustments to the balance of the loan are required to calculate the affected loan balance, which simplifies the required calculations.

Example 61: Private expenditure

On 26 March 2021, Ariana owes $500,000 on a revolving credit facility used to fund her residential rental property. Her initial loan balance is $500,000. Although the balance of the revolving credit facility, and therefore the affected loan balance, fluctuates as she receives rent and pays expenses, by 30 September 2021 the affected loan balance is $460,000. The affected loan balance remains below $500,000 until Ariana withdraws $70,000 on 1 April 2023 to buy a car for personal use. This increases the balance of the revolving credit facility from $460,000 to $530,000. However, the affected loan balance remains at $460,000 as the revolving credit facility balance is adjusted down by the private expenditure of $70,000.

The interest affected by limited denial of deductibility under section DH 10(3) from 1 April 2023 is calculated based on the lower of:

- the initial loan balance = $500,000, and
- the affected loan balance = $530,000 – $70,000 = $460,000

Ariana's interest that is affected by limited deductibility would therefore be calculated by multiplying the affected loan balance of $460,000 by the interest rate. Multiplying that amount by the relevant percentage in section DH 8(2) would then provide the non-deductible portion. The portion of the revolving credit facility used to buy the car ($70,000), and any interest charged on that amount, is fully non-deductible.

Example 62: Significant repayment

On 26 March 2021, Kristina owes $500,000 on a revolving credit facility used to fund her residential rental property. Her initial loan balance is $500,000. The balance of the revolving credit facility, and therefore the affected loan balance, fluctuates as she receives rent and pays expenses, and by 30 September 2021 the affected loan balance is $520,000. For the period the affected loan balance is above the initial loan balance, Kristina is only entitled to deductions for the interest calculated on the initial loan balance of $500,000. For the period the affected loan balance is below the initial loan balance, Kristina would calculate her interest deductions based on the affected loan balance, rather than the initial loan balance.

On 17 April 2023, she receives an inheritance of $200,000 and uses it to reduce the balance of the revolving credit facility, and thus the affected loan balance, from $550,000 to $350,000. As this is below the initial loan balance, Kristina can deduct 50% of the interest after applying the 50% denied deduction percentage under section DH 8(2) for the 2023–24 year.

On 3 August 2024, Kristina withdraws $100,000 from the revolving credit facility to renovate her rental property. The balance of the revolving credit facility, and thus the affected loan balance, increases from $370,000 to $470,000. This work does not qualify for the new build exemption. As this is not private expenditure, nor fully deductible, no adjustments are needed to Kristina's affected loan balance.

As the balance of the revolving credit facility, and thus the affected loan balance, is below the initial loan balance, Kristina is entitled to deduct 25% of the interest after applying the 75% denied deduction percentage under section DH 8(2) for the 2024–25 year.

Example 63: Detailed calculation

Mikkel has a revolving credit facility that he used to fund his DRP. On 26 March 2021, the facility has a balance of $500,000. The following transactions occur:

- Interest is charged at 4% x 1/12 on the closing monthly balance.
- Rent of $2,400 is deposited on the 1st day of each month.
- $5,000 is withdrawn on 15 May 2021 and spent on private expenditure.

- $20,000 is withdrawn on 10 August 2021 and spent on Mikkel's separate taxable business.
- On 20 November 2021, $6,500 is withdrawn and spent on repairs to the DRP.

Mikkel's initial loan balance is $500,000 and he calculates the loan balance that has interest deductions limited under section DH 8(2) as follows:

Date	Transaction	Amount	Loan Balance	Affected Loan Balance	Loan Balance under s DH 10(3)	
26-Mar-21	End of day balance		-500,000	-500,000		
31-Mar-21	Interest	-1,667	-501,667	-501,667		
1-Apr-21	Rent	2,400	-499,267	-499,267		
30-Apr-21	Interest	-1,664	-500,931	-500,931		
1-May-21	Rent	2,400	-498,531	-498,531		
15-May-21	Private expenditure	-5,000	-503,531	-498,531		Private expenditure not deductible and affected loan balance does not increase
31-May-21	Interest[30]	-1,678	-505,209	-500,209		
1-Jun-21	Rent	2,400	-502,809	-497,809		
30-Jun-21	Interest	-1,676	-504,485	-499,485		
1-Jul-21	Rent	2,400	-502,085	-497,085		
31-Jul-21	Interest	-1,674	-503,759	-498,759		
1-Aug-21	Rent	2,400	-501,359	-496,359		

[30] $5,000 x 0.04 ÷ 12 x 16/31 = $6.45 of interest relates to private expenditure so would also be added back to the affected loan balance. For simplicity, this example assumes no adjustments to the affected loan balance for private and business interest charges.

10-Aug-21	Business expenditure	-20,000	-521,359	-496,359		Business expenditure fully deductible and affected loan balance does not increase
31-Aug-21	Interest	-1,738	-523,097	-498,097		
1-Sep-21	Rent	2,400	-520,697	-495,697		
30-Sep-21	Interest	-1,736	-522,432	-497,432		
1-Oct-21	Rent	2,400	-520,032	-495,032	-495,032	
31-Oct-21	Interest	-1,733	-521,766	-496,766	-496,766	
1-Nov-21	Rent	2,400	-519,366	-494,366	-494,366	
20-Nov-21	House repairs	-6,500	-525,866	-500,866	-500,000	Expenditure on DRP. Affected loan balance goes above initial loan balance
30-Nov-21	Interest	-1,758	-527,619	-502,619	-500,000	
1-Dec-21	Rent	2,400	-525,219	-500,219	-500,000	
31-Dec-21	Interest	-1,756	-526,970	-501,970	-500,000	
1-Jan-22	Rent	2,400	-524,570	-499,570	-499,570	Affected loan balance goes below initial loan balance
31-Jan-22	Interest	-1,754	-526,318	-501,318	-500,000	Affected loan balance goes above initial loan balance

1-Feb-22	Rent	2,400	-523,918	-498,918	-498,918	Affected loan balance goes below initial loan balance

The private expenditure and business expenditure are adjusted from the affected loan balance. This is an identical calculation to that required under the legislation to determine the amount of deductible interest allocated to the rental property.

Until 30 September 2021, the interest limitation proposals do not apply, so the balance that generates interest deductible against the rental property is the affected loan balance.

Between 1 October 2021 and 19 November 2021, the affected loan balance is lower than the initial loan balance so interest on the affected loan balance is deductible subject to the 25% denial in section DH 8(2).

On 20 November 2021, the house repairs take the affected loan balance above the initial loan balance. Therefore, between 20 November 2021 and 31 December 2021, interest on the $500,000 initial loan balance is deductible subject to the 25% denial. Interest on the difference between the affected loan balance and the initial loan balance, which varies between $219 and $2,619 during this period, is non-deductible under section DH 8(1).

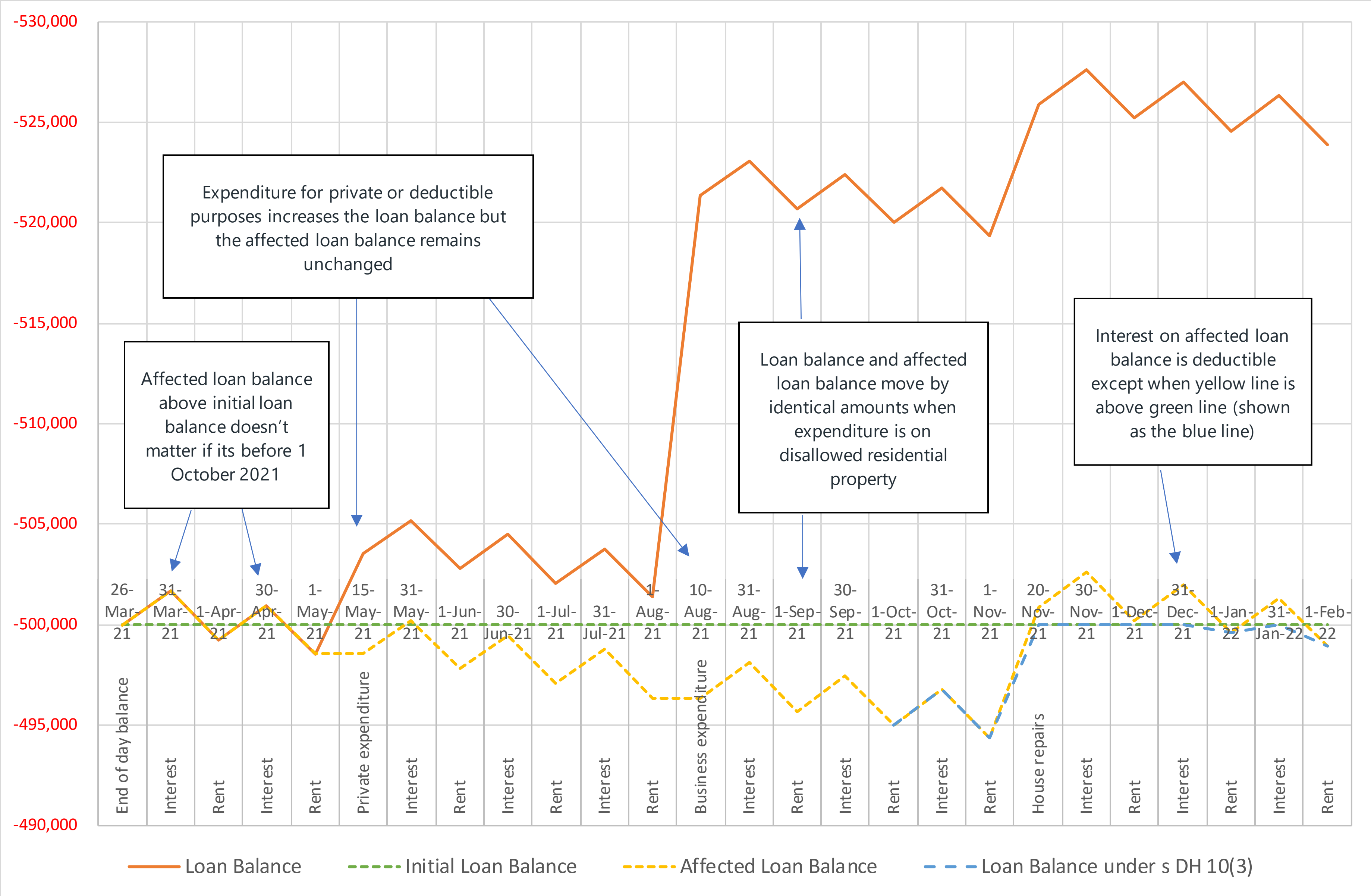
On 1 January 2022, the rent payment reduces the affected loan balance below the initial loan balance. Between 1 January 2022 and 30 January 2022, interest on the affected loan balance is deductible subject to the 25% denial.

On 31 January 2022, the interest charged increases the affected loan balance above the initial loan balance. For that day, interest on the initial loan balance is deductible subject to the 25% denial. Interest on the difference between the initial loan balance and the affected loan balance of $1,318 is non-deductible.

On 1 February 2022, the rent payment reduces the affected loan balance below the initial loan balance. Interest on the affected loan balance is deductible subject to the 25% denial. This will remain the case until 31 March 2023, provided the affected loan balance remains below $500,000.

This example can also be shown in a graph on the following page.

Inland Revenue
Te Tari Taake



Refinancing

Section DH 5(5)(e) and (f)

A taxpayer with a loan that is a grandparented transitional loan (or would have been such a loan if it had been in New Zealand dollars) can take out a second loan to repay the first loan. The second loan, provided it is in New Zealand dollars, follows the treatment of the first loan. It is therefore treated as being for the disallowed residential property (DRP) and the interest should be grandparented residential interest.

Application date

The new provisions apply to refinancing on or after 27 March 2021.

Detailed analysis

Interest deductions for a grandparented transitional loan are progressively denied by section DH 8(2). A taxpayer can refinance that grandparented transitional loan by taking out a second New Zealand dollar loan and using the proceeds to repay the first loan. In these circumstances, the purpose of the first loan and the deductibility of interest on that loan are maintained for the second loan.

A taxpayer that has a foreign currency loan for DRP would not have a grandparented transitional loan as the loan would not meet the definition of that term in section DH 5(5). Consequently, interest on such a loan is non-deductible after 1 October 2021. If the taxpayer refinances such a loan with a New Zealand dollar loan, and the other criteria are met, the new loan will meet the definition of “grandparented transitional loan”. Deductions for interest incurred on the New Zealand dollar loan will then be progressively denied under section DH 8(2) until 31 March 2025, when interest on that New Zealand dollar loan also becomes fully non-deductible.

Rollover relief – transfer of disallowed residential property

Sections CB 6AB, CB 6AC, DH 5(5)(d), and FC 9B(a) to (e) of the Income Tax Act 2007

Rollover relief is provided for certain transfers or disposals of disallowed residential property (DRP) to ensure that grandparented residential interest on a grandparented transitional loan remains deductible throughout the full transition period of 1 October 2021 to 31 March 2025.

Relief is available for some transfers to or from family trusts and to or from look-through companies and partnerships. Specific relief applies to transfers to trusts constituted under Te Ture Whenua Māori Act 1993.

Relief is also available for relationship property settlements, certain company amalgamations, and transfers on death.

Background

The new interest limitation rules deny deductions for interest incurred on loans on or after 1 October 2021 where those loans are drawn down on or after 27 March 2021 for DRP.

Loans drawn down before 27 March 2021 are grandparented transitional loans, meaning that interest deductions are progressively denied over the period from 1 October 2021 to 31 March 2025 as grandparented residential interest. In limited circumstances, loans drawn down on or after 27 March 2021 also qualify as grandparented transitional loans.[31]

In general, simple refinancing does not result in a loan losing its grandparented transitional loan status. However, this may not be the case for a person with a grandparented transitional loan who restructures the legal ownership of the property and the accompanying loan on or after 27 March 2021. In the absence of rollover relief, the person may no longer be considered to have a grandparented transitional loan and will not be entitled to deduct any interest expense incurred for the property from 1 October 2021 or for the remainder of the transition period to 31 March 2025. This is the case even if the economic ownership of the property remains the same.

Providing rollover relief is therefore justified on equity grounds in some ownership-change scenarios where *economic* ownership has not materially changed.

Key features

Rollover relief is available for the purposes of subpart DH and determining whether a loan is a grandparented transitional loan when DRP:

- is transferred under a settlement of relationship property

[31] For more on grandparented transitional loans and grandparented residential interest, see the "Grandparented residential interest" section of this special report.

- passes from an amalgamating company to the amalgamated company on a resident's restricted amalgamation, or
- is transferred, following the death of the owner of the property, to an executor or administrator of the estate or to a beneficiary of the estate.

This is consistent with existing rollover relief available under the bright-line test.

Family trusts

Rollover relief is also provided for some transfers of DRP to or from family trusts. This is provided that:

- each transferor (in the case of transfers to a trust) or each recipient (in the case of transfers from a trust back to a settlor) of the DRP is also a beneficiary of the trust
- at least one of those transferors or recipients of the DRP is also a principal settlor of the trust
- each principal settlor is a beneficiary of the trust and a close family associate, and
- each beneficiary is either a close family beneficiary or trustee of another trust with at least one beneficiary that is a close family associate of a beneficiary of the first trust.

For rollover relief to apply when the trustees of a family trust of the type described above transfer the property back to its original settlors, each recipient's proportionate interest in the property has to be the same as in the original settlement of the property on the trust.

Relief is available when DRP is transferred back to the original owner and then settled on a new trust, so rollover relief should also be available for a pure resettlement transaction where the trustees of the trust transfer the DRP to a new trust. While this is not currently provided for in the new legislation, it is intended that rollover relief for such resettlement transactions should be introduced in the next available tax bill.

Specific rule for Māori family trusts

Specific relief is also provided for land subject to Te Ture Whenua Māori Act 1993. Rollover relief applies for transfers to a Māori authority (or a person eligible to be a Māori authority) as the trustee of a trust if:

- the DRP is subject to Te Ture Whenua Māori Act 1993
- the transferors are all beneficiaries, and

- the beneficiaries of the trust are all either:
  - members of the same iwi or hapū, or
  - descendants of the same tipuna (living or dead).

Similar to the rule for general family trusts, relief is also available when the trustees of a Māori trust of the type described above transfer the DRP back to the settlors of the property, provided those settlors are beneficiaries of the trust. It is intended that for rollover relief to apply when the trustees of a trust of the type described above transfer the property back to its original settlors, each recipient's proportionate interest in the property has to be the same as in the original settlement.

As above, relief for resettlement transactions is not provided for in the new legislation, but it is intended that rollover relief should be available and should be introduced in the next available tax bill.

Transfers to or from look-through companies (LTCs) and partnerships

Rollover relief also applies to transfers of DRP to or from LTCs and partnerships. This is intended to apply where each person transferring the DRP to the LTC or partnership (or acquiring it from the LTC or partnership) has the same ownership interest in the property before and after the transfer.

Application date

The provisions came into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Detailed analysis

New section DH 5(5)(d) provides for rollover relief for the purposes of subpart DH and determining whether a loan is a grandparented transitional loan when DRP is transferred:

- under a settlement of relationship property
- from an amalgamating company to the amalgamated company on a resident's restricted amalgamation
- following the death of the owner of the property, to an executor or administrator of the estate or to a beneficiary of the estate
- to or from a family trust in certain circumstances

- to or from trustees in certain situations where the DRP is subject to Te Ture Whenua Māori Act 1993, and
- to or from LTCs and partnerships in certain circumstances.

If the requirements for rollover relief are satisfied, the recipient effectively steps into the shoes of the transferor (the original owner with the grandparented transitional loan). This ensures that the recipient can deduct a reducing portion of their interest expense incurred during the period 1 October 2021 to 31 March 2025 for the DRP in accordance with section DH 8(2). The recipient still needs to satisfy the other requirements in the Income Tax Act 2007 to be able to deduct the interest expense (for example, satisfying the general permission and not being subject to a general limitation).

In each case, the recipient's maximum grandparented transitional loan cannot exceed the transferor's loan balance at the time of the disposal – that is, if they borrow more than the transferor owes at the time of transfer, the excess part of the loan is not grandparented, and interest on that excess is not grandparented residential interest and is not deductible.

Relationship property settlements

New section DH 5(5)(d) provides that rollover relief applies to a transfer of DRP made under existing section FB 3A on a settlement of relationship property on or after 27 March 2021 if the previous owner of the DRP (the original owner) had a grandparented transitional loan. "Settlement of relationship property" is defined by existing section FB 1B(a) as a transaction under a relationship agreement[32] that creates a disposal and acquisition of property between two persons who are both either a party to the agreement or associated with a party to the agreement.

This means that certain loans drawn down by, or transferred to, the recipient of DRP under a relationship agreement on or after 27 March 2021 up to 31 March 2025 meet the requirements of new section DH 5(5) and are grandparented transitional loans. This will be the case if the loan held by the transferor before the relationship property settlement was also a grandparented transitional loan. However, the recipient's loan is only a grandparented transitional loan (and interest on it will only be grandparented residential interest) to the extent that the loan balance does not exceed the transferor's loan balance at the time of the transfer.

[32] A relationship agreement is defined in section YA 1 as an agreement for the purpose of Part 6 of the Property (Relationships) Act 1976 or an order under section 25 of that Act that is made by the person or the court on or after 28 July 1983.

The recipient of the property is entitled to deduct a reducing portion of their grandparented residential interest expense during the remaining transition period to 31 March 2025 in accordance with the percentages set out in section DH 8(2). This is provided the general requirements for deducting expenses are met (for example, a nexus with income exists).

Example 64: Relationship property settlement

Dale and Dawn, a married couple, decide to separate in April 2022. As part of the relationship property settlement, they agree that Dale will keep the family home and Dawn will keep the investment property they acquired back in 2003, shortly after they got married. Dawn decides to retain the property as an investment rather than move into it herself. There is an existing mortgage over the property that has an outstanding loan balance of $20,000. Dawn has agreed to take this over.

Since the loan was drawn down before 27 March 2021, the loan is a grandparented transitional loan and the interest on the loan is grandparented residential interest. Dale and Dawn are entitled to deduct 75% of the amount of mortgage interest they each incurred for the property over the period from 1 October 2021 to 31 March 2022.

Rollover relief applies to the transfer of Dale's share of the property to Dawn in April 2022, so the $20,000 loan continues to be a grandparented transitional loan, and Dawn is entitled to deduct a reducing amount of interest over the remaining period to 31 March 2025.

Company amalgamations

Section DH 5(5)(d) also provides that rollover relief applies to a transfer of property as part of a company amalgamation under existing section FO 17. Relief applies when DRP passes from an amalgamating company to the amalgamated company on a resident's restricted amalgamation on or after 27 March 2021, provided the amalgamating company had a grandparented transitional loan. A resident's restricted amalgamation is defined in section FO 3. Effectively, rollover relief is only available if the amalgamating company and amalgamated company are New Zealand resident and are not treated as non-resident under a tax treaty. This is to ensure that, consistent with the rules for bright-line rollover relief, rollover relief for interest limitation is provided on the condition the property remains within the New Zealand tax base. Once again, the amalgamated company's grandparented transitional loan balance cannot exceed the amalgamating company's loan balance at the time of transfer.

Example 65: Company amalgamation

In March 2015, A Co, a close company, purchases several residential apartments. On 1 October 2021, the properties are transferred from A Co to another close company, B Co, as part of an amalgamation. The amalgamation qualifies as a resident's restricted amalgamation under section FO 3 of the Income Tax Act 2007. Immediately before the transfer, A Co has a grandparented transitional loan balance of $2.5 million.

Rollover relief applies to the transfer to B Co in October 2021, meaning that any loans held by B Co for the DRP up to a total value of $2.5 million are deemed to be grandparented transitional loans. B Co is therefore entitled to deduct a reducing amount of interest for any such loans over the transition period (1 October 2021 to 31 March 2025) as grandparented residential interest.

Inherited property

When a person dies, all their property (their estate) is transferred to the executor appointed under the deceased's will or, if there is no will, the administrator of the estate appointed by the court. The executor or administrator is then responsible for dealing with any taxes and debts due out of the estate and distributing any remaining property to the beneficiaries of the estate.

Generally, all the deceased's debt will be repaid by their estate when they die, provided there are sufficient assets to cover the debt. Even if the debt is not repaid in full, any remaining debts are not required to be repaid by the beneficiaries of the estate. However, there may be some situations where a property with a registered mortgage is transferred to a beneficiary of the estate because the beneficiary is willing to voluntarily make the mortgage repayments so that they may keep the property.

Section DH 5(5)(d) provides that rollover relief applies in certain instances to a transfer of inherited DRP in accordance with existing section FC 9 following the death of the original owner if the original owner had a grandparented transitional loan. This includes when the property is transferred to an executor or administrator, or to a beneficiary of the deceased's estate, on or after 27 March 2021. The result is that interest on a loan transferred to, or serviced by, the recipient of the property continues to be grandparented residential interest on a grandparented transitional loan if the deceased had a loan for the same property that qualified as a grandparented transitional loan under new section DH 5(5). This entitles the recipient of the property to deduct interest in accordance with the grandparented residential interest rules in subpart DH for the remainder of the transition period to 31 March 2025. This is only to the extent that the loan balance does not exceed the grandparented transitional loan balance at the time of the transfer of the property.

This ensures the following:

- If the property was held by the deceased as a rental property, the executor or administrator (when filing the estate's income tax return) is entitled to deduct at least some of the interest incurred by the estate starting on 1 October 2021 up to 31 March 2025 (if any) on any loans for the property that were still outstanding at the time of death of the owner.
- A beneficiary of the estate inheriting the DRP potentially also benefits from the transition period, as they will be able to deduct some of the interest on the grandparented transitional loan to 31 March 2025. This assumes the beneficiary will be repaying or taking over any loans for the property not fully repaid by the deceased's estate.

Example 66: Inherited property

Pat purchased a house as a private residence for himself in 2010 and borrowed $200,000 at that time to finance the purchase. In his will, Pat has provided that all his property is inherited by his son, Robin, when he dies.

At the time of Pat's death in July 2021, $40,000 is still owing on the loan. This loan is a grandparented transitional loan. Robin would like to keep Pat's house and use it as a rental property to supplement his income, so he agrees with the executors of Pat's estate that he will obtain a loan from another bank to repay the loan outstanding to Pat's bank.

Robin borrows $90,000 – of which $40,000 is used to repay Pat's bank and the remaining $50,000 is used to fund renovations before Robin finds tenants.

Rollover relief applies to the transfer of the property to Robin, meaning that Robin is deemed to have a grandparented transitional loan. However, the grandparenting rules only apply to $40,000 of Robin's loan, as that is the amount that was owing at the time of Pat's death.

Robin is entitled to deduct a reducing amount of interest for $40,000 of his loan over the transition period (1 October 2021 to 31 March 2025) as grandparented residential interest.

Family trusts

Section DH 5(5)(d) also provides rollover relief for transfers of DRP to or from trustees in certain situations. The section applies to every transfer of the DRP since the original owner acquired it that meets the requirements of sections FC 9B(a) or (b) (which link to sections CB 6AB(1) and (2) respectively), treating the relevant requirements of that section as applying to a transfer of DRP on after 27 March 2021 (rather than a transfer of residential land on or after 1 April 2022).

This means rollover relief applies in certain cases when DRP is transferred to the trustees of a family trust (section CB 6AB(1)) or is transferred from the trustees back to the person (original settlor) who originally settled it on the trust (section CB 6AB(2)).

Transfers to family trusts

Section DH 5(5)(d) applies by way of section CB 6AB(1) when a trustee receives a transfer of DRP to a "rollover trust". For transfers to a trust, a "rollover trust" is defined in section CB 6AB(5) to mean, at the time of a relevant transfer:

- all relevant transfers to trustees are by people who are beneficiaries of the trust, at least one of whom is a principal settlor of the trust
- all principal settlors are beneficiaries of the trust
- all principal settlors are close family associates, and
- all beneficiaries are either close family beneficiaries, or the trustees of another trust of which at least one beneficiary is a close family associate of a beneficiary of the trust in question.

"Close family beneficiary" is defined in section CB 6AB(6) as, for the relevant trust, a beneficiary that is at least one of the following:

- A principal settlor.
- A close family associate of another beneficiary who is also a principal settlor.
- A company in which a 50 percent or more voting interest (or a market value interest of at least 50 percent, if a market value circumstance exists) is owned by a beneficiary that is a close family associate of another beneficiary that is a principal settlor.
- A charity registered under the Charities Act 2005.

Under section CB 6AB(7), two persons are close family associates if one or more of the following applies:

- they are within four degrees of blood relationship (paragraph (a))
- they are married, in a civil union, or in a de facto relationship (paragraph (b)), or
- one person is within four degrees of blood relationship to the other person's spouse, civil union partner, or de facto partner (paragraph (c)).

This definition includes relatives by adoption, as section 16(2) of the Adoption Act 1955 deems adopted children to be the natural children of their adoptive parent.
Section CB 6AB(7)(c) (the third bullet point above) also extends coverage of the association test to include stepchildren and in-laws.

The rules mirror the existing associated person rules in section YB 4 but with an expansion from two degrees to four degrees of association. This is to account for the fact that many family trusts include a wider range of family members than simply those only two degrees removed.

A non-exhaustive list of some common examples of familial relations that meet the "close family associates" test is as follows (references are to paragraphs in the section CB 6A(7) definition):

- The principal settlor's parents and children (one degree of blood relationship – paragraph(a)).
- The principal settlor's grandchildren, grandparents and siblings (two degrees of blood relationship – paragraph (a)).
- The principal settlor's aunts, uncles, nieces, nephews, great-grandchildren, and great-grandparents (three degrees of blood relationship – paragraph (a)).
- The principal settlor's cousins, great-nieces, great-nephews, and great-great-grandchildren (four degrees of blood relationship – paragraph (a)).
- The principal settlor's spouse or de facto partner (paragraph (b)).
- The principal settlor's stepparents, stepchildren, step-siblings, parents-in-law, brothers-in-law, sisters-in-law, daughters-in-law or sons-in-law (within four degrees of blood relationship to the spouse or de facto partner – paragraph (c)).

Further information on how degrees of association are determined in family situations can be found in IR620.[33]

[33] IR620 *A guide to associated persons definitions for income tax purposes*, available at www.ird.govt.nz

Section CB 6AB(8) ensures that rollover relief does not apply when shares in an LTC holding DRP are transferred to or from trustees.

Example 67: Sale to family trust 1

Neo acquired a rental property and drew down a loan of $500,000 for the property on 3 March 2017. The rental property is DRP. The loan is a grandparented transitional loan.

On 29 October 2022, Neo sells the DRP to his family trust for $450,000. He and his son, Archie, are beneficiaries of the trust. Neo's outstanding balance of his loan at the time of transfer is $400,000. The trustee takes out a loan of $450,000 to purchase the property from Neo. Neo uses $400,000 of the sale proceeds to repay the outstanding balance of his loan.

The transfer of the DRP to the trust qualifies for rollover relief and therefore enables the trustee to deduct limited interest deductions until 31 March 2025. However, only interest on $400,000 of the trustee's loan is deductible as grandparented residential interest. Interest on the additional $50,000 borrowed does not qualify for rollover relief and is not deductible. This is because the $50,000 exceeds the balance of Neo's grandparented transitional loan at the time of transfer and is not part of the trustee's grandparented transitional loan.

Example 68: Sale to family trust 2

Maude acquired an investment property in 2017 using a combination of savings and a loan from the bank. In April 2021, Maude sold the property to her family trust, the beneficiaries of which are her and her adult children, Fran and Josiah. At the time of sale, the outstanding balance on Maude's grandparented transitional loan is $150,000. To finance the purchase of the property, the trustees of the trust borrow $150,000 from the bank.

Rollover relief applies to the transfer of the property. This means the trustees have a grandparented transitional loan with a balance of $150,000 and interest incurred on the loan is grandparented residential interest.

Transfers from family trusts to the original settlors

Section CB 6AB(2) applies if DRP is transferred back to a person (the original settlor) from a rollover trust that the person originally settled. For transfers from the trust, section CB 6AB(5) defines "rollover trust" to mean, at the time of a relevant transfer to the original settlor:

- all relevant transfers to original settlors are to people who are beneficiaries of the trust, at least one of whom is a principal settlor of the trust
- all principal settlors are beneficiaries of the trust
- all principal settlors are close family associates, and
- all beneficiaries are either close family beneficiaries, or the trustees of another trust of which at least one beneficiary is a close family associate of a beneficiary of the trust in question.

For section CB 6AB(2) to apply, subsection (3) provides that the DRP transferred back to the original settlor by the trustees of the trust must either be:

- the same DRP they originally settled, and all other original settlors also get their DRP back, or
- in part the same DRP they originally settled if that part and all other transfers back to other original settlors are in the same proportions as in the original settlement on the trust.

Relief under section CB 6AB(2) does not apply where DRP held on trust is transferred to a beneficiary who is not the original settlor of the DRP. For example, if a parent transfers a residential property to a family trust, the beneficiaries of which are that parent and their children, section CB 6AB(2) would only apply if the trustee transfers the DRP back to the parent, not if the DRP is transferred to the children.

Transfers to or from different capacity (LTCs, partnerships)

Relief may also apply in certain cases under section CB 6AB when:

- DRP is transferred from an LTC or partnership to a family trust (where DRP may be settled on the trust by a person in a different capacity to the capacity in which they are a beneficiary), or
- a person receives DRP back from a trust they settled it on, but in a different capacity to the capacity in which they settled it.

Section CB 6AB(3) provides that, for the purposes of applying subsection (1) (where a person transfers DRP to a trust) or subsection (2) (where an original settlor receives DRP back from a trust), the person may transfer DRP to, or receive it from, the trust in different capacities. For example, A and B may have settled the DRP on the trust in their own personal capacities, but they may have it transferred back to them in their capacity as shareholders in an LTC.

Example 69: Transfer from partnership to family trust

Susan and Rhiannon, a married couple, are the two partners in a partnership, the S & R Partnership (the Partnership) and the principal settlors of the S & R Trust (the Trust). Both Susan and Rhiannon are beneficiaries of the Trust, and all the other beneficiaries of the Trust are either associated with both Susan and Rhiannon within four degrees of blood relationship or are associated with Susan within four degrees of blood relationship. This includes their adult son, Mark (who is Rhiannon's biological son and was adopted by Susan, and so is treated under the law as Susan's natural child) and grandchildren, as well as Susan's children and grandchildren from her previous relationship.

The Partnership purchased an investment property in 2015 for $535,000. The Partnership settles the investment property on the Trust in August 2021, at which time the outstanding balance of the mortgage on the property is $100,000. The trustees of the Trust provide consideration of $900,000 to the Partnership for the property. The trustees borrow $300,000 from the bank for the purchase of the property and fund the remainder of the purchase price with equity.

Partial rollover relief applies to the transfer of the property, meaning that the trustees have a grandparented transitional loan balance of $100,000 (being the amount of the Partnership's grandparented transitional loan balance on the date of the transfer). The trustees' excess loan balance of $200,000 does not qualify for rollover relief.

Resettlements of trusts

It is intended that rollover relief should be available for trust resettlements when the trustees of the trust transfer the DRP to the trustees of another trust, provided that a principal settlor of the new trust is also a principal settlor of the first trust and the new trust satisfies all the requirements of section CB 6AB(5) in relation to its beneficiaries. However, the current legislation does not permit a direct resettlement to qualify for rollover relief, unless the trustee resettling the property is a beneficiary of the new trust. It is intended that an amendment should be included in the next available tax bill.

Māori family trust rule

Section DH 5(5)(d) provides rollover relief for transfers of DRP subject to Te Ture Whenua Māori Act 1993 to trustees in certain situations outlined in sections FC 9B(d) or (e) (which link to section CB 6AC(1) and (2) respectively). This recognises that land subject to Te Ture Whenua Māori Act 1993 has alienation restrictions that lead to interests in land being passed from generation to generation. These interests are often fragmented and can result in a large number of owners all belonging to the same iwi or hapū or who are all descendants of the same tipuna.

Section DH 5(5)(d) applies to every transfer of the DRP since the original owner acquired it that meets the requirements of section FC 9B(d) or (e), treating the relevant requirements as applying to a transfer of DRP on after 27 March 2021 (rather than a transfer of residential land on or after 1 April 2022).

This means rollover relief applies in certain cases when DRP is transferred to the trustees of a Māori family trust (section CB 6AC(1)) or is transferred from the trustees back to a person (the original settlor) who originally settled it on the trust (section CB 6AC(2)).

Transfers to Māori family trusts

Section CB 6AC(1) applies when a Māori trustee holds DRP subject to Te Ture Whenua Māori Act 1993 on a Māori rollover trust. For transfers to a trust, "Māori rollover trust" is defined in section CB AC(4) to mean, at the time of a relevant transfer:

- all relevant transfers to the trustees of the trust are by people who are beneficiaries of the trust
- all beneficiaries of the trust are either members of the same iwi or hapū, or descendants of the same tipuna (living or dead), and
- the DRP is subject to Te Ture Whenua Māori Act 1993.

Section CB AC(5) defines "Māori trustee" as a trustee of a trust that is either a Māori authority or eligible to be a Māori authority under existing section HF 2(3)(e)(i).

Example 70: Sale of property subject to TTWM Act to trust eligible to be a Māori authority

Rewi and several of his family members hold interests in a parcel of land that is subject to Te Ture Whenua Māori Act 1993. All the family members are descendants of Rewi's late great-great-grandfather. Several townhouses are on the land, and these are all rented out to tenants. In 2023, Rewi and his relatives decide to sell their interests in the land to a family trust that was settled by Rewi for the benefit of all surviving descendants of Rewi's great-great-grandfather. The trust is eligible to be a Māori authority under section HF 2(3)(e)(i), but it has not elected to be one.

Rewi and his relatives took out a loan in 2019 to finance improvements to some of the townhouses on the land. This loan is a grandparented transitional loan. At the time of the sale to the trustees in 2023, $120,000 was still outstanding on the loan.

The trustees take out a loan for $500,000 to fund part of the purchase price of $1m. Rollover relief applies to the transfer of the property, meaning that the trustees are deemed to have a grandparented transitional loan, but the amount of that loan is limited to the transferors' loan balance of $120,000 that was outstanding at the time of the sale. The interest incurred on the $120,000 is grandparented residential interest and is partially deductible until 31 March 2025. Interest on the remaining $380,000 balance of the trustees' loan is not deductible.

Transfers from Māori family trusts to the original settlors of the trust

Section CB 6AC(2) applies if DRP is transferred back to a person (referred to here as the "original transferor", although the legislation uses the term original settlor) from a trustee of a Māori rollover trust that was originally settled by that person. For transfers from a trust, a "Māori rollover trust" is defined to mean, at the time of a transfer to an original transferor:

- the original transferors are also beneficiaries of the trust
- all beneficiaries of the trust are either members of the same iwi or hapū or descendants of the same tipuna, and
- the DRP is subject to Te Ture Whenua Māori Act 1993.

For section CB 6AC(2) to apply, subsection (3) provides that the DRP transferred back to the original transferor by the trustees of the trust must either be:

- the same DRP they originally settled on the trust, and all other original transferors also get their DRP back, or
- in part the same DRP they originally settled on the trust if that part and all other transfers back to other original transferors are in the same proportions as in the original settlement on the trust.

Transfers to or from different capacity (LTCs, partnerships)

Relief may also apply in certain cases under section CB 6AC when DRP is transferred between a Māori rollover trust and an LTC or partnership. Section CB 6AC(3) provides that, for the purposes of applying subsection (1) (where a person transfers DRP to a Māori rollover trust) or subsection (2) (where an original transferor receives DRP back from a Māori rollover trust), the person may transfer DRP to, or receive it from, the trust in different capacities. For example, A and B may have settled the DRP on the trust in their own personal capacities, but they may have it transferred back to them as partners in a partnership.

Resettlements of Māori family trusts

It is intended that rollover relief should be available when DRP subject to Te Ture Whenua Māori Act 1993 is resettled on another family trust, provided certain conditions are met. That is, when the trustees of the trust transfer the property to the trustees of another trust that is also a Māori authority, or eligible to be one, provided the two trusts have a settlor in common and the beneficiaries of the new trust are all members of the same iwi or hapū, or descendants of the same tipuna. However, the current legislation does not permit a direct resettlement to qualify for rollover relief unless the trustee resettling the property is also a beneficiary of the new trust. It is intended that an amendment should be included in the next available tax bill.

Transfers by or to persons in their capacity as look-through company owners or partners in a partnership

Shareholders in LTCs are treated as directly holding the LTCs' assets, deriving income and incurring expenses in accordance with their shareholding percentage. In effect, LTCs are transparent for tax purposes, which means that the income tax consequences for someone who holds DRP through an LTC are generally the same as for someone who holds DRP directly. Partnerships are also transparent for tax purposes.

Section DH 5(5)(d) provides rollover relief for a transfer to which section FC 9B(c) applies (which, in turn, links to section CB 6AB(4)), treating the relevant requirements as applying to a transfer of DRP on after 27 March 2021 (instead of a transfer of residential land on or after 1 April 2022).

Relief applies if a person transfers DRP to themselves in a different capacity, and there is no intervening transfer to a third party. This provides rollover relief for transfers between LTCs and the LTC shareholders or between partnerships and the partners.

The section is intended to apply to transfers of DRP to or from LTCs and partnerships where each person transferring the DRP to the LTC or partnership (or acquiring it from the LTC or partnership) has the same ownership interest in the property before and after the transfer. It is also intended to apply when DRP is transferred from an LTC to another LTC with identical shareholding (meaning that the two LTCs have the exact same owners who each hold the exact same proportion of shares in the second LTC as they hold in the first LTC).

Example 71: Transfer to look-through company

Mary and Bob, a married couple, are the shareholders in a look-through company, Company X. They each hold 50 percent of the shares in Company X. Mary and Bob jointly own an investment property in equal shares. Mary and Bob had drawn down a loan in 2018 to purchase the property. In September 2021, the loan has an outstanding balance of $100,000 and is a grandparented transitional loan.

In September 2021, Mary and Bob sell the property to Company X for $850,000. Company X borrows $150,000 from the bank for the purchase of the property and uses its equity to fund the remainder of the purchase price. Partial rollover relief applies to the transfer of the property, meaning that Company X has a grandparented transitional loan balance of $100,000 (being the amount of Mary and Bob's grandparented transitional loan balance on the date of the transfer). Company X's excess loan balance of $50,000 does not qualify for rollover relief.

Interest limitation and mixed use assets

Sections DG 2(3B), DG 9(1), DG 10(1B), DG 11(1)(b), DG 14(4), and DH 6 of the Income Tax Act 2007

The interest limitation rules apply to property such as baches or holiday homes that are rented out on a short-term basis. For most such property, the apportionment of expenditure between income-earning and other uses is specifically provided for in subpart DG of the Act, which applies to expenditure incurred in relation to mixed use assets (MUAs). The interest limitation rules apply to determine whether the amount of interest apportioned to the income-earning use of a residential property MUA, either under subpart DG or otherwise, is deductible.

For most residential property MUAs, applying the interest limitation rules and the MUA rules concurrently should be relatively straightforward. However, in the unusual case where a residential property MUA is held by a close company, more complex rules must be applied. This is because the two sets of rules apply different approaches to determine what interest is allocated to the residential property MUA.

As a general principle, the interest limitation rules only apply to interest that *relates to* (in other words, can be *traced* to) ownership of mixed use residential property. Interest that is allocated to mixed use residential property under the special rules in sections DG 10 to DG 13 (which do not apply tracing) is not subject to the interest limitation rules

Key features

New section DG 2(3B) ensures the deductibility of interest subject to apportionment under sections DG 8 and DG 9 that is incurred in relation to disallowed residential property (DRP) is subject to denial under subpart DH.

New section DG 10(1B) provides that interest incurred in relation to DRP or to acquire an ownership interest in, or become a beneficiary of, an interposed residential property holder (IRPH), as well as the associated debt, is ignored for the purposes of sections DG 11 to DG 13. While it is not clear in the new legislation, it is intended that this interest will be apportioned using the formula in section DG 9, and an amendment to ensure this result should be introduced in the next available tax bill.

Interest incurred that relates to an interest in an IRPH for which a deduction is already denied under section DH 8(1)(c) is removed from the application of section DG 14.

MUAs are removed from the definition of "disqualified assets" in section DH 6(2)(a) to ensure that such assets give rise to a loss of a deduction for interest incurred by a shareholder only under the mixed use asset rules.

Application date

The new provisions came into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Detailed analysis

When interest expenditure is subject to apportionment under sections DG 8 and DG 9 and it relates to DRP, new section DG 2(3B) ensures the deductibility of that expenditure is subject to the application of the new interest limitation rules in subpart DH (and not conclusively resolved by section DG 8(1)). A deduction is not allowed for that portion of the interest expenditure identified as deductible by section DG 8(1) that is denied under new section DH 8.

This treatment does not apply to interest expenditure subject to apportionment under sections DG 11 to DG 13 (referred to in those sections as the "reduced amount", see examples below). Those sections relate to assets held in corporate structures. Interest expenditure subject to those provisions does not relate to the asset under the tracing approach that applies for subpart DH. Instead, it is allocated to the asset under the "stacking" approach set out in sections DG 11 to DG 13. This means that the interest is not subject to denial under subpart DH.

In applying the stacking approach, interest incurred that relates to a DRP or acquiring an ownership interest in an IRPH, as well as the associated debt, is not taken into account, since the interest on the debt is already subject to apportionment under sections DG 8 and DG 9 and to denial under section DH 8.

Example 72: Mixed use assets held directly

RB Ltd is a close company. For the year ended 31 March 2023, RB Ltd owns a holiday home, which is both a MUA and DRP, and a boat, which is also a MUA. The holiday home has a rateable value of $180,000 and the boat has a depreciated value of $60,000. The company has debt of $150,000, $50,000 of which was used to acquire the holiday home and meet expenses related to it, and $100,000 of which was used to acquire the boat and meet miscellaneous expenses related to it. The holiday home debt bears interest at 5% and the remaining debt bears interest at 5.5%, giving RB Ltd a total interest expense of $8,000 for the year. The formulas in sections DG 8 and DG 11 produce an income-earning use percentage of 45% for the holiday house and 70% for the boat.

Section DG 8 will apply to determine the apportionment between private and income-earning purposes of the $2,500 of interest for the holiday home. The 45% (or $1,125) that is allocated to income-earning purposes, and is therefore deductible under section DG 8(1), would nevertheless be non-deductible under section DH

8(1)(a). If the loan is a grandparented transitional loan, the deduction may be progressively denied under section DH 8(2) until 31 March 2025. The non-deductible portion remaining (after any partial allowance under section DH 8(2)) may be allowed if the sale of the property is taxable.

Because RB Ltd is a close company and has debt that is not traced to DRP or an IRPH (that is, the $100,000), it must apply section DG 11. In applying section DG 11, RB Ltd disregards the $50,000 of traced debt and associated $2,500 of interest. RB Ltd can apply section DG 11 first to either the holiday home or the boat. Generally, it would apply the section first to the asset with the higher percentage of income-earning use. In this case, that is the boat.

Applying section DG 11 to the boat first, RB Ltd determines that its debt value of $100,000 exceeds its asset value of $60,000. Section DG 11(2) therefore requires RB Ltd to apply sections DG 11(4) to (6). Section DG 11(4) calculates a reduced amount of $5,500 x $60,000/$100,000, or $3,300. RB Ltd is therefore allowed a deduction of 70% of that amount under section DG 11(6), or $2,310.

Because RB Ltd has a remaining MUA (that is, the holiday home), RB Ltd must undertake the same calculations for the holiday home and the remaining unallocated debt amount of $40,000. In this case, the asset value must be determined by reducing the value of the holiday home by the debt related to it under a tracing approach. The asset value is therefore $130,000. This is more than the remaining debt value of $40,000, and so section DG 11(3) applies. RB Ltd is allowed a deduction of $990, calculated as $2,200 (being $5,500 – $3,300) x 45%.

Of RB Ltd's total interest expenditure of $8,000 incurred in the year ended 31 March 2023:

- $1,375 is apportioned under section DG 8 to private use of the holiday home and is non-deductible.
- $1,125 is apportioned under section DG 8 to income-earning use of the holiday home and, under subpart DH, 25% of this amount, or $281.25, is non-deductible and 75%, or $843.75, is deductible.
- $3,300 is allocated to the boat under section DG 11 and 70%, or $2,310, of this is deductible.
- $2,200 is allocated to the holiday home under section DG 11 and 45% or $990 of this is fully deductible. Subpart DH does not apply to this interest

because it is allocated to the holiday home under the stacking approach in section DG 11, not the tracing approach.

Example 73: Mixed use asset and interest incurred by a holding company

RB Ltd in example 72 had a net asset value of $90.000. Suppose that RB Ltd is 100% owned by HB Holdings Ltd, which has debt of $1M and interest expense of $50,000.

First variation: Interest does not relate to RB Ltd shares

Assume that none of HB Holdings' debt was borrowed to acquire the shares in RB Ltd. In this case, subpart DH does not apply to any of HB Holdings' interest. However, section DG 12 does apply. HB Holdings therefore has to split its $50,000 of interest into a portion that is subject to disallowance under DG 12 (being $90,000/$1M) and a portion that is not. The portion subject to disallowance is $4,500, and of this, 55% or $2,475 will be non-deductible. Subpart DH does not apply to deny a deduction for the remaining $2,025

Second variation: Interest does relate to RB Ltd shares which are not an interest in IRPH

Assume that $100,000 of HB Holdings' debt was borrowed to acquire shares in RB Ltd. Ordinarily, those shares would be an interest in an IRPH since the value of the holiday home is more than 10% of the value of all of RB Ltd's assets (see the definition of an "interposed residential property holder" in section DH 5(6)). On that basis, a portion of the interest on the traced debt would be non-deductible under section DH 8(1)(c). However, because of section DH 6(2)(a)(ii), an asset that is subject to subpart DG is not included in the numerator in determining a company's interposed residential property percentage.

However, section DG 12 still applies to deny a portion of HB Holdings' interest deduction as per the first variation.

Third variation: Interest does relate to RB Ltd shares which are an interest in IRPH

Assume the home is a long term rental, so not subject to subpart DG (see section DG 3(4)(b)). Section DG 11 only applies to the interest allocated to the boat under section DG 11, which is the product of RB Ltd's total interest cost ($8,000) x the value of the boat/the amount of all borrowing by RB Ltd ($60,000/$150,000) =

$3,200. Since the private use percentage of the boat is 30%, $960 of RB Ltd's interest deductions will be denied under section DG 11.

If the home is a new build or otherwise not subject to subpart DH, there is no more interest to deny. However, assume that it is subject to subpart DH. In this case, because the home is not subject to subpart DG, HB Holdings' shares in RB Ltd are an interest in an IRPH. If none of HB Holdings' debt relates to the RB Ltd shares, there will be no interest disallowed under subpart DH. However, if $100,000 of HB Holdings' debt does relate to the RB Ltd shares under tracing, then the interest on that debt x RB Ltd's interposed residential property percentage will be denied by section DH 8(1)(c). This is a quarterly calculation. Assuming that the only assets in RB Ltd are the boat and the home, the interposed residential property percentage will be $180,000/$240,000, giving a percentage of 75%. Given the interest rate on the debt of 5%, this will result in disallowance of $100,000 x 5% x 75% = $3,750.

Fourth variation

Assume the facts are the same as the third variation, except that RB Ltd has no borrowing. Section DH 8(1)(c) applies, as in the third variation, to disallow $3,750 of HB Holdings' interest expense. The change in facts means that there is a net asset balance of $60,000 (the value of the boat) in RB Ltd. Assuming that HB Holdings is the company that applies section DG 12, this means that a further $60,000 of its debt is effectively related to the boat. Given the 5% interest rate and the 30% private use, this will result in additional interest denial of $60,000 x 5% x 30% = $900.

Example 74: Interposed residential property holder

Hinemoa owns 100% of the shares in Whare Limited. Whare Limited's only assets are three houses, as follows:

- 10 Moana Ave, which is a MUA and has a value of $1.5M. The private use percentage is 60%.
- 20 Cluny Rd, which is a non-new build long-term rental and has a value of $600,000.
- 33 Motuhara Rd, which is a new build long-term rental and has a value of $900,000.

Whare Ltd has no debt, but Hinemoa has borrowed $1M to acquire the shares in Whare Ltd. The interest on the debt for the relevant year is $40,000.

Whare Limited has an interposed residential property percentage under section DH 6 of $600,000/$3,000,000, since the MUA is excluded from the numerator under section DH 6(2). Since this is 20%, Hinemoa's shares are an interest in an IRPH (section DH 5(6)). This means 20% of the $40,000 of interest deductions for the year (or $8,000) is non-deductible under section DH 8((1)(c). This is equivalent to saying that $200,000 of the debt gives rise to non-deductible interest.

Whare Limited also has a net asset balance of $1.5M, being the value of 10 Moana Avenue less the debt of zero. This means that all Hinemoa's interest on the $1M used to buy the shares in Whare Ltd is subject to section DG 14, less the 20% already dealt with under subpart DH. That leaves $32,000 of interest to be dealt with. Under sections DG 11(3B), DG 13(5), and DG 14, , this means allowing an interest deduction for only 40% of the $32,000, or $12,800, since that reflects the income earning use of 10 Moana Avenue.

Loans in foreign currency

Section CW 62C of the Income Tax Act 2007

Income arising from a foreign currency loan that is used for disallowed residential property (DRP) and denied interest deductions under section DH 8(1) is exempt income.

Application date

The amendment came into force on 27 March 2021 with application to income derived on or after 1 October 2021.

Detailed analysis

DRP may be financed by a loan denominated in a foreign currency. Unlike a New Zealand dollar loan, a loan in foreign currency can result in assessable income, under the financial arrangements rules, if the person has a foreign exchange gain for the year. To ensure symmetry between potential income and expenditure on the same loan, section CW 62C treats income arising from a foreign currency loan used for DRP as exempt income.

The effect of section CW 62C is that the treatment of foreign currency loans for DRP is consistent with New Zealand dollar loans, except that foreign currency loans are not eligible for the progressive denial of interest deductions between 1 October 2021 and 31 March 2025 under section DH 8(2). This is because a foreign currency loan cannot be a grandparented transitional loan, and therefore interest on the foreign currency loan will not be grandparented residential interest.[34]

Treatment of denied interest deductions on disposals of disallowed residential property

Section DH 11 of the Income Tax Act 2007

Interest that has been denied a deduction under the interest limitation rules may be deductible in the year of disposal of the disallowed residential property (DRP) if the disposal is taxable.

Key features

As a general rule, interest that has been denied a deduction under the interest limitation rules will be deductible in the year of disposal of the DRP if the disposal is taxable. However, the result may differ depending on whether the property is taxable under the bright-line test or is taxable under other tax rules. The difference arises primarily in relation to any tax loss on the sale of the DRP.

Specifically, if the amount derived on disposal of the DRP is taxed under the bright-line test, the amount of the previously denied interest is treated as if it were part of the cost of the property. This means that if the sale results in a net loss, the deduction for the net loss is limited under the existing rule that applies to losses from the disposal of bright-line property. Any excess net loss can be carried forward.

If, instead, the amount derived on disposal of the DRP is taxable because of the application of other rules, the amount of the previously denied interest is allowed as a deduction in the year of disposal. However, the interest, together with other expenditure for the property or portfolio, will be subject to the residential rental loss ring-fencing rules if they apply. This will usually be the case if the property is subject to interest limitation.

[34] For more on this, see the "Grandparented residential interest" section of this special report.

If the disposal of the DRP is not taxable, the interest previously denied a deduction under new section DH 8 remains non-deductible.

Note that none of the above is relevant if any of the exemptions for land business, development or new builds applies. In those situations, the interest is not subject to the interest limitation rules and is deductible in the year it is incurred, provided the general deductibility criteria are met. Also, note that any grandparented residential interest deductions previously allowed are not deductible again on disposition of the DRP.

Application date

The new provision came into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Detailed analysis

General criteria

New section DH 11 allows interest that was previously denied a deduction under new section DH 8 to be deductible in the year of disposal of the DRP if the disposal is on revenue account. If the disposal is on capital account (that is, any gain is not taxable, and any loss is not deductible), any interest previously denied deductibility under new section DH 8 remains non-deductible.

The following scenarios are discussed in more detail below:

- Interest not previously deductible under general rules is still non-deductible even when any gain on disposal of the DRP is taxed (for example, under the bright-line test).
- Interest denied a deduction when it is incurred under the interest limitation rules is added to the cost of the DRP on its disposal when it is taxed under the bright-line test.
- Interest denied a deduction when it is incurred under the interest limitation rules may be deducted on disposal of the DRP when it is taxed under another land sale provision (other than the bright-line test). However, the interest may be subject to the residential rental loss ring-fencing rules.
- Interest that can still be deducted when it is incurred, for example, because the property is exempt from the interest limitation rules or the interest is grandparented

residential interest, continues to be deductible provided the general deductibility criteria are met.

Interest that is not deductible when it is incurred under general rules

For interest to be deductible, the interest must still meet the requirements of the ordinary rules of deductibility, such as satisfying the general permission in section DA 1 – that is, requiring interest to be earned in connection with earning income. This excludes interest denied under any of the general limitations in section DA 2, such as the private limitation. These rules all continue to apply even when the DRP is taxed on disposal under the bright-line test. If the interest was not deductible when it was incurred, it will not become deductible when the DRP is disposed of.

Example 75: Sale of bach subject to the bright-line test

Jack and Aria buy a bach in November 2021 for $700,000. They borrow $400,000 at 4% interest to complete the purchase. Six years later, in October 2027, they sell the bach for $750,000. They paid a total of $96,000 interest.

Only Jack and Aria, and their friends and family, used the bach. They did not rent it out.

The amount derived on the sale of the bach will be taxable under the 10-year bright-line test. None of the $96,000 interest they paid is deductible in the year of sale because, regardless of section DH 8, the interest would not have been deductible when it was incurred. This is because the bach was used for personal purposes and was not used to derive taxable income. The result is that the gain on sale of $50,000 is income under the bright-line test and none of the interest is deductible.

Interest previously denied where disposal taxed under the bright-line test

If the amount derived on disposal of the DRP is income under the bright-line test, the amount of the interest previously denied under subpart DH is treated as if it were part of the cost of the DRP under section DB 23. If this results in a net loss, the deduction for the net loss is limited under the anti-arbitrage rule that applies to losses from the disposal of bright-line property.

The anti-arbitrage rule in existing section EL 20 provides that a net loss from a bright-line disposal may only be deducted to the extent of net taxable gains the taxpayer has from other land sales in the year of the disposal. Any excess net loss deduction (that is, the amount by which the net loss exceeds the net taxable land sale gains) is carried forward and may be used in future years against other taxable land sale gains of the taxpayer. This rule is necessary because, by choosing to dispose of the property before the end of the bright-line period, a taxpayer can ensure the disposal is on revenue account and therefore deduct a loss that could not be deducted if they waited until after expiration of the bright-line period.

Allowing a deduction for the previously denied interest expense in the year of a taxable disposal would raise the same arbitrage issue. Disposing of the DRP before the expiration of the bright-line period would mean the interest was deductible, whereas waiting until after the expiration of that period would mean that it was not. To address this, new section DH 11(1) provides that, for bright-line disposals, the previously denied interest is deemed to be part of the cost of the DRP, rather than being deductible. The cost of the DRP may be deductible in the year of disposal (under section DB 23), but the anti-arbitrage rule in section EL 20 will apply if there is a net loss on sale. However, the net loss can be carried forward and used in future income years

Example 76: Sale of rental property subject to the bright-line test

Assume the same facts as example 75, except that Jack and Aria bought a rental property instead of a bach. The $96,000 interest they paid would have been deductible if section DH 8 had not applied, because the property was used to derive taxable income. Therefore, the interest is potentially deductible in the year of sale.

The property was bought for $700,000 and sold for $750,000 six years later. In the year of sale, the $750,000 sale price is income under the bright-line test, and the cost of the property may be deducted under section DB 23. Section DH 11(1) provides that the original cost of $700,000 is deemed to be increased by the disallowed interest of $96,000. However, section EL 20 provides that, in the year of sale, the amount of the deduction is limited to income from the sale ($750,000) plus net gains from other taxable land sales.

Assuming this is the only property Jack and Aria sell that year, the deduction is therefore limited to $750,000 (resulting in no net income to be taxed or loss deducted). This means only $50,000 of the disallowed interest is deductible. The excess amount of $46,000 is carried forward and applied against any taxable land sale gains Jack and Aria have in later years.

Interest previously denied where disposal taxed under another land sale provision

If the disposal of a DRP is taxable under another land sale provision, other than the bright-line test, there is not the same level of concern with arbitrage. The character of the disposal as taxable or non-taxable cannot usually be determined by choosing the time of the disposal. In this case, the anti-arbitrage rule does not apply, but the residential rental loss ring-fencing rules do (new section DH 11(2)).

In this case, the interest that has previously been denied a deduction under subpart DH retains its character as interest. It is not re-characterised as part of the cost of the property (as is the case if the disposal is taxed under the bright-line test). Any gain on sale of the DRP is taxable and any loss deductible. The previously denied interest is deductible, but it is subject to the residential rental loss ring-fencing rules.

Application of the residential rental loss ring-fencing rules means the previously denied interest, and any other expenditure, is netted off against the residential income from the property or portfolio. "Residential income" is defined in section EL 3 and includes the rental income and any net land sale income from the property or portfolio. If the total deductions exceed the residential income, the treatment of the excess deductions (that is, the net loss from the property or portfolio) depends on whether the residential rental loss ring-fencing rules are being applied on an individual property or portfolio basis.

If the rules are being applied on a portfolio basis (that is, together with other properties), the net loss in the year of a taxable disposal is deferred and carried into the next income year to be deducted against later residential property income. However, if the taxpayer is applying the rules on an individual property basis, the net loss is usually fully deductible in the year of the taxable disposal.

Interest that continues to be deductible when incurred

Interest that remains deductible when it is incurred includes:

- interest incurred before 1 October 2021
- grandparented residential interest, being interest relating to pre-27 March 2021 property and debt that is allowed partial deductions during the transition period from 1 October 2021 to 31 March 2025[35], and

[35] See the "Grandparented residential interest" section of this special report for more detail.

- interest not subject to the interest limitation rules because one of the land business, development, or new build exemptions applies[36].

Such interest cannot be deducted again upon disposal of the property.

Interest may be deductible when incurred but contribute to a net rental loss that is suspended as a deduction and carried forward under the residential rental loss ring-fencing rules. Such interest is also not automatically deductible in the year of disposal. Refer to the discussions above for the treatment of the interest on disposal.

Interposed entity rules

Sections DH 5(6), DH 6 and DH 8(1)(c) of the Income Tax Act 2007

Subpart DH contains interposed entity rules to support the integrity of the interest limitation rules. The interposed entity rules ensure that a person cannot circumvent the interest limitation rules by borrowing indirectly through an interposed company or trust that holds the disallowed residential property (DRP).

Key features

The interposed entity rules deny interest deductions for a person who indirectly holds DRP through an interposed residential property holder (IRP holder). An IRP holder can be a company or a trust that is not a unit trust.[37]

The interposed entity rules do not generally apply to look-through companies (LTCs) and partnerships that have DRP.[38] Under the LTC and partnership tax rules,[39] LTCs and partnerships are treated as transparent, and a person with an ownership interest in the LTC or partnership is treated as directly holding any DRP that the LTC or partnership may hold (in proportion to their effective look-through interest or partnership share).

The interposed entity rules apply when a person incurs interest to acquire an ownership interest in a company or to become a beneficiary of a trust, and the company or trust has an interposed residential property percentage (IRP percentage) over the relevant threshold. The

[36] See the "Exemptions for new housing supply – overview" and following sections of this special report for more detail.
[37] Unit trusts are treated as companies for tax purposes.
[38] An exception may apply if an interposed close company elects to become an LTC.
[39] In subpart HB (LTCs) and subpart HG (partnerships).

IRP percentage is the value of the company or trust's DRP (with some exclusions) as a percentage of the value of their total assets.

The relevant IRP percentage threshold differs depending on whether the DRP is held by a close company, a non-close company, or a trust. The relevant threshold is:

- For a close company, 10 percent at the end of a quarter in the income year.
- For a company that is not a close company, 50 percent at any time in the income year.
- For a trust, 10 percent at any time in the income year.

If the relevant threshold is exceeded, the company or trust is an IRP holder for the person.

If the IRP holder for a person is a close company, the interest incurred by the person to acquire an ownership interest in the company is limited in proportion to the company's IRP percentage.

If the IRP holder for a person is a non-close company or a trust, all interest incurred by the person to acquire an ownership interest in the company or to become a beneficiary of the trust is denied.

Application date

The interposed entity rules came into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Detailed analysis

Deduction denied

New section DH 8(1)(c) provides that a person is denied a deduction for interest if and to the extent to which the interest is incurred to acquire an ownership interest in, or become a beneficiary of, an IRP holder.

Interposed residential property holder

"Interposed residential property holder" is defined in new section DH 5(6).

An IRP holder for a person may be one of three types of DRP holders:

- A close company for which the person has voting interests or market value interests and the company has, at the end of any quarter in the income year, an IRP percentage of more than 10 percent.
- A non-close company for which the person has voting interests or market value interests and the company has, at any time during the income year, an IRP percentage of more than 50 percent.
- Trustees of a trust of which the person is a direct or indirect beneficiary, and the relevant trust has, at any time during the income year, an IRP percentage of more than 10 percent.

Interposed residential property percentage

"Interposed residential property percentage" is defined in new section DH 6. For an IRP holder, it is the amount calculated using the following formula and expressed as a percentage:

$$\text{disqualified assets} \div \text{total assets}$$

where:

- **Disqualified assets** is the value of the IRP holder's DRP but excluding property subject to the new build, land business or development exemptions. For a close company, it also excludes property subject to the mixed-use asset rules in subpart DG. This is because such property is dealt with separately under the regime in subpart DG.
- **Total assets** is the total value of the IRP holder's assets.

New section DH 6(3) contains a special rule to deal with the situation where a company holds interests in subsidiary companies that hold DRP. The company's "disqualified assets" and "total assets" are calculated by applying the existing look-through rule in section YC 4. For the purposes of the special rule, however, the company is treated as the ultimate shareholder and the assets held by the subsidiary companies are attributed to the company in proportion to its ownership interests in the subsidiary companies. For example, assume a person holds shares in Holdco Ltd and Holdco holds 50 percent of the shares in Subco Ltd. If Subco owns DRP and other assets, 50 percent of Subco's DRP and other assets are attributed to Holdco when calculating Holdco's IRP percentage.

Section DH 12 applies to determine the value of land and other property for the IRP percentage formula.

Valuation for purposes of subpart DH

Section DH 12 sets out the valuation rules for the purposes of subpart DH. For land not covered by the land business or development exemptions, it depends on whether the land was acquired before or after the most recent local authority valuation. Land acquired before the most recent local authority valuation is valued at its most recent capital or annual value set by a local authority. Land acquired after the most recent local authority valuation is valued at its acquisition cost, if it was acquired from a non-associated person, or its market value, if it was acquired from an associated person.

Other property, including land covered by the land business or development exemptions, is valued using its tax book value. However, if a person prepares financial accounts in accordance with relevant accounting or legislative standards, the property is valued using the financial accounts' valuation.

Interposed close companies

Interposed close companies present the greatest integrity concerns. This is because control can be concentrated in a single natural person, or a small group of natural persons, and a close company can be easily established to hold DRP indirectly. This concern is reflected in the 10 percent IRP percentage threshold and quarterly calculation requirement for close companies that hold DRP.

10 percent threshold

New section DH 5(6)(a) provides that a close company is an IRP holder for a person if the person has voting interests (generally, shares) or market value interests in the company and the company has, at the end of a quarter in the income year, an IRP percentage of more than 10 percent.

To reduce compliance costs, the 10 percent de minimis threshold ensures that shareholders of close companies with very small amounts of DRP as a proportion of their total assets do not have to apply the interposed entity rules.

Quarterly calculation and denial of interest in proportion to IRP holder's IRP percentage

New section DH 8(1)(c) provides that a person is denied a deduction for interest to the extent it is incurred to acquire an ownership interest in, or become a beneficiary of, an IRP holder. If the IRP holder is a close company, the amount of deduction denied is then limited under sections DH 8(3) and (4), so that the amount denied is in proportion to the close company's quarterly IRP percentage.

New sections DH 8(3) and (4) sets out the formula for the quarterly calculation as follows:

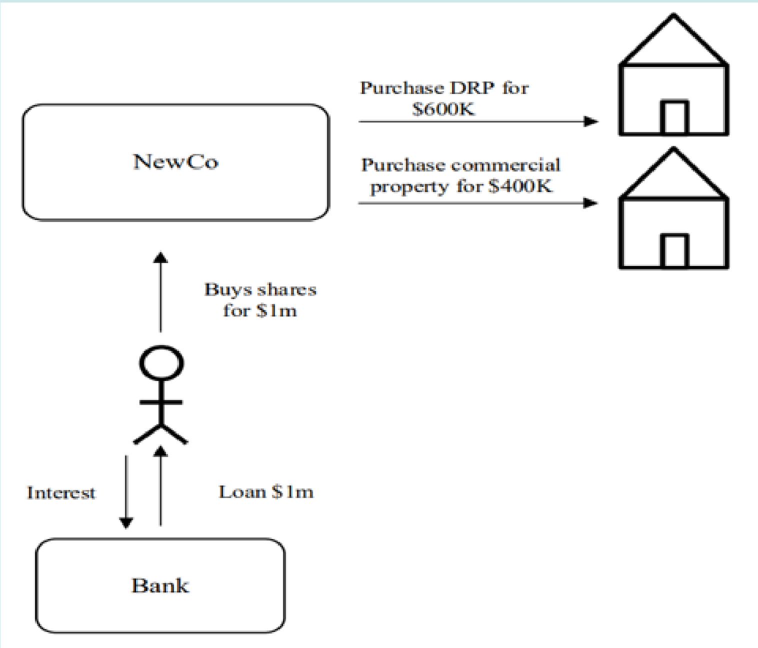
interposed interest × quarterly IRP percentage

where:

- **Interposed interest** is the amount of the interest incurred by the person in the relevant quarterly calculation period,
- **Quarterly IRP percentage** means the IRP percentage for the close company at the end of the relevant quarterly calculation period.

The total of the amounts denied in each quarter is the amount of interest that is denied under s DH 8(1)(c) for the income year.

Example 77: Interposed close company rule



Catherine borrows $1 million from Bank. She sets up a company, NewCo, and is issued 1,000 shares at $1,000 per share. NewCo buys a DRP for $600,000 and a commercial property for $400,000 using the share issuance proceeds at the start of the income year. Assume for simplicity that NewCo's assets do not change throughout the income year.

Under section DH 6, NewCo's disqualified assets are $600,000 and its total assets $1 million. NewCo's IRP percentage is 60 percent at the end of each quarter.

NewCo is an IRP holder for Catherine under section DH 5(6)(a). Applying section DH 8, 60 percent of the interest incurred by Catherine during the income year on the $1 million loan used to acquire shares in NewCo is denied.

Interposed non-close companies

50 percent threshold

Under new section DH 5(6)(b), a company that is not a close company will be an IRP holder for a person if the person has voting interests or market value interests in the company and the company has, at any time during the income year, an IRP percentage of more than 50 percent.

The higher IRP percentage threshold of 50 percent for non-close companies ensures that shareholders in non-close companies will not have to apply the interposed entity rules unless the company's assets consist mainly of disqualified assets. In practice, companies that do not hold DRP as a main part of their business are likely to have an IRP percentage well below the 50 percent threshold.

All interest denied

Under new section DH 8(1)(c), if a person incurs interest to acquire an ownership interest in an IRP holder that is a non-close company, all interest incurred by the person is denied.

The denial of all interest incurred by the person is a simplification measure to avoid an apportionment approach like the one that applies to interposed close companies under sections DH 8(3) and (4). Although apportionment is more accurate, it would usually be much more complex for shareholders in non-close companies to apply.

Interposed trusts

New section DH 5(6)(c) provides that the trustees of a trust (that is not a unit trust) are an IRP holder for a person who is a direct or indirect beneficiary of the trust if the trust, at any time in the income year, has an IRP percentage of more than 10 percent.[40]

For income tax purposes, a unit trust is treated as a company.[41] If a unit trust holds DRP and a person has incurred interest to participate as a beneficiary in the unit trust, the person would need to determine whether the unit trust was an IRP holder under either section DH 5(6)(a) or (b), rather than section DH 5(6)(c).

If a trustee (of a non-unit trust) is an IRP holder for a person, all interest incurred by the person to become a beneficiary of the trust is denied under new section DH 8(1)(c). Applying an apportionment approach, like the one for interposed close companies, to an interposed (non-unit) trust would usually be impossible, as a person's control or ownership of a trust cannot be readily measured. The denial of all interest incurred is therefore a simplification measure. In practice, it would be very uncommon for a person to incur interest to become a beneficiary of a (non-unit) trust.

Look-through companies and partnerships

The interposed entity rules do not apply to persons who borrow to acquire shares in a look-through company (LTC), or a partnership share in a partnership, that has DRP. This is because LTCs and partnerships are transparent for income tax purposes.

Under section HB 1, owners of LTCs are treated as holding any property held by the LTC in proportion to the owner's effective look-through interest[42] in the LTC, and the LTC is treated as not holding the property. If a person incurs interest to acquire shares in an LTC, the person is treated as incurring interest to acquire any DRP held by the LTC in proportion to their effective look-through interest.

[40] Existing subpart EL contains interposed entity rules for residential rental loss ring-fencing. Those rules also provide for the possibility of an interposed trust that is not a unit trust.
[41] The definition of "company" in section YA 1 includes a unit trust. "Unit trust" is defined in section YA 1 and means "a scheme or arrangement that is made for the purpose or has the effect of providing facilities for subscribers, purchasers, or contributors to participate, as beneficiaries under a trust, in income and capital and capital gains arising from the property that is subject to the trust".
[42] "Effective look-through interest" is defined in section HB 1(5). In broad terms, it is the number of shares held by a person in an LTC as a percentage of all the shares issued by the LTC.

Similarly, under section HG 2, partners of partnerships are treated as holding any property held by the partnership in proportion to the person's partnership share[43] in the partnership, and the partnership is treated as not holding the property. If a person incurs interest to acquire a partnership share, the person is treated as incurring interest to acquire any DRP held by the partnership in proportion to their partnership share.

Close company electing to be an LTC

It is possible for a close company that is an IRP holder to make an election to become an LTC. New section DH 6(4) provides that if a shareholder of a close company incurs interest on borrowings to acquire an ownership interest in that company, and the borrowings were drawn down before the effective date of the LTC election,[44] the shareholder is to apply the interposed close company rules[45] to determine the amount of interest that is denied after the effective date of the LTC election.

This is a simplification measure to avoid the complexities of transitioning pre-election borrowings to a look-through approach after the effective date of the LTC election.

After the effective date of the LTC election, if a person borrows to acquire an ownership interest in the LTC, the interposed close company rules will not apply to interest on those borrowings and the transparency rule in section HB 1 will instead apply. The person will be treated as incurring the interest to acquire DRP held by the LTC in proportion to their effective look-through interest.

Specific anti-avoidance rules

Sections GB 53B and GB 53C of the Income Tax Act 2007

New sections GB 53B and GB 53C are specific anti-avoidance rules to support the integrity of the interest limitation rules in subpart DH.

Key features

New section GB 53B addresses situations where a change in value affects the interposed residential property percentage (IRP percentage) calculation for an interposed residential

[43] "Partnership share" is defined in section YA 1 and means, for property, the share that a partner has in the partnership.
[44] The effective date of an LTC election is determined under section HB 13.
[45] Sections DH 5(6)(a), DH 6, and DH 8(1)(c), (3) and (4).

property holder (IRP holder).[46] It applies if the change in value is caused by an act or omission, or is produced by an arrangement, that has a purpose or effect of defeating the intent and application of subpart DH. If section GB 53B applies, the change in value is ignored in calculating the IRP percentage of the IRP holder.

New section GB 53C addresses arrangements where a person (on-lender) on-lends borrowed money to an associated person who has DRP, and the on-lending is at a lower rate of interest than the rate payable by the on-lender. For the new section to apply, the arrangement must have a purpose or effect of defeating the intent and application of subpart DH. If the section applies, the amount of interest deductible by the on-lender is limited to, and calculated using, the lower rate, with the higher rate being ignored.

Application date

New sections GB 53B and GB 53C came into force on 27 March 2021.

Detailed analysis

Section GB 53B – Increases or decreases in value

The IRP percentage determines whether a company or trust is an IRP holder for a person. If it is, interest incurred by that person may be subject to limitation. The IRP percentage also determines the amount of interest denied if an IRP holder is a close company.

New section GB 53B addresses situations where:

- there is a change in value that affects, or would affect, the result of the IRP percentage calculation for an IRP holder, and
- the change in value has a purpose or effect of defeating the intent and application of subpart DH.

A change in value that defeats the intent and application of subpart DH could occur, for example, by a disposal shortly before a calculation date and a re-acquisition after that date. For example, a close company may dispose of DRP shortly before a quarterly calculation date so that its IRP percentage falls below the 10 percent threshold required for it to be an IRP holder. That company may then reacquire the same or similar DRP shortly after the calculation date. If the change in value is caused by an act or omission, or is produced by an

[46] For detailed analysis on the IRP percentage and IRP holders, see the "Interposed entity rules" section of this special report.

arrangement, that has a purpose or effect of defeating the intent and application of subpart DH, the change in value is ignored when calculating the IRP percentage of the IRP holder.

Section GB 53C – On-lending at lower rate

New section GB 53C addresses situations where a person (the on-lender) indirectly funds DRP by borrowing money and on-lending the money at a lower rate to an associated person who either owns DRP or is associated with a person who owns DRP (the DRP holder).

Although the interest at the lower rate incurred by the DRP holder might be denied under subpart DH, the higher rate of interest paid by the on-lender on the borrowings that, in economic reality, funded the DRP might not be subject to any limitation in the absence of an anti-avoidance rule. The specific on-lending anti-avoidance rule in section GB 53C ensures that on-lending arrangements with a purpose or effect of lowering the amount of interest denied under subpart DH are not effective.

Section GB 53C applies when there is an arrangement that involves a person on-lending money at a lower rate to an associated person who owns DRP (or whose associate owns DRP) and the arrangement has a purpose or effect, not being a merely incidental purpose or effect, of defeating the intent and application of subpart DH. If the arrangement has such a purpose or effect, the amount of interest incurred by the on-lender for the purposes of Part D is limited to, and calculated using, the lower interest rate (payable by the DRP holder). The higher interest rate payable by the on-lender is ignored. This means the on-lender will not be able to claim a deduction for the higher interest rate.

Example 78: On-lending at a lower rate

Zeean is the sole shareholder of LandCo. She borrows $800,000 from her bank at a 5% interest rate and on-lends the money to LandCo, at a 1% interest rate. LandCo uses the money to acquire DRP.

LandCo's 1% interest expenditure on the loan from Zeean is subject to limitation under subpart DH because LandCo used the borrowed funds to acquire DRP.

In the absence of an anti-avoidance rule, Zeean's 5% interest expenditure on her loan from the bank may not be subject to limitation. This is because she used the borrowed funds to derive interest income from LandCo, rather than for DRP or to acquire a share in an interposed company.

If the particular facts indicate that the arrangement has a more than merely incidental purpose or effect of defeating the intent and application of subpart DH, Zeean's deductible interest expenditure will be limited to 1%, even though her actual interest expenditure is 5%.

Purpose or effect of defeating the intent and application of subpart DH

Sections GB 53B and GB 53C require a purpose or effect of defeating the intent and application of subpart DH. A considerable body of case law exists on when an arrangement has the purpose or effect of defeating the intent and application of the Income Tax Act, or a part of the Act. It is intended that this case law will inform the meaning and application of these sections.

Bright-line test changes – background and overview

This section provides an overview of two sets of changes to the bright-line test. The first is the introduction of a new 5-year bright-line test for new build land (the 5-year new build bright-line test). The second relates to the exclusion from the bright-line test for main homes. Both sets of changes are only relevant to land acquired on or after 27 March 2021.

What is the bright-line test and how long does it apply for?

The bright-line test taxes gains from residential land disposed of within a specified period after acquisition. Land will be taxed if disposed of within five or ten years of acquisition unless an exclusion applies to the land.[47] The length of the bright-line period depends on when the land was acquired:[48]

[47] There are exclusions for main homes, inherited property, and land transferred under settlements of relationship property – see sections CB 6A(12), CB 16A, FB 3A, and FC 9.
[48] In a typical land purchase, the date of acquisition is the date a sale and purchase agreement is entered into, even if there are still some conditions to be satisfied – like obtaining finance or a building report.

Acquisition date	Length of bright-line period
29 March 2018 to 26 March 2021 (inclusive)	Five years
On or after 27 March 2021[49]	Five years for certain new build land
	Ten years for all other residential land

5-year new build bright-line test

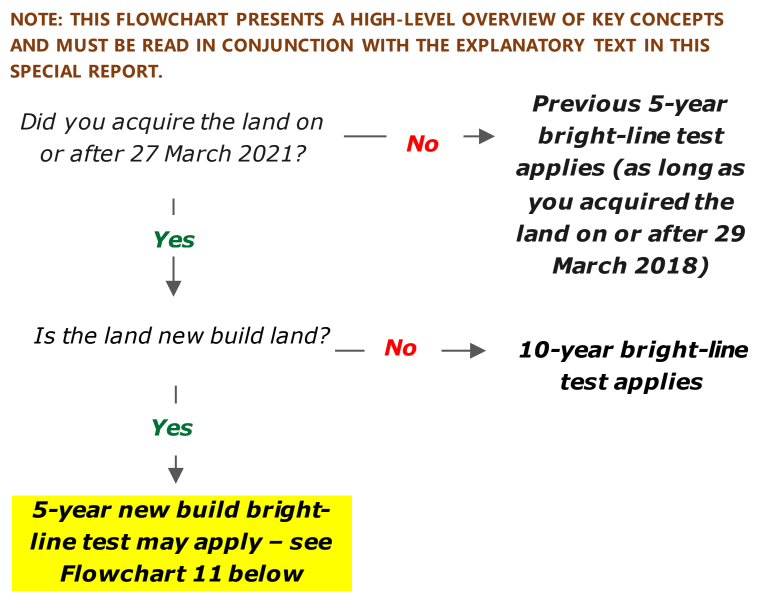
A 5-year new build bright-line test has been introduced for new build land that meets certain criteria.[50] This test is only relevant for new build land that is acquired on or after 27 March 2021.

The new rules regarding main homes that were introduced for the 10-year bright-line test apply for the 5-year new build bright-line test.[51]

See the "5-year new build bright-line test" section of this special report for more information on the test.

The table below summarises the different tests.

Flowchart 9: Which bright-line test applies?



[49] But not to residential land acquired on or after 27 March 2021 as a result of an offer made by the purchaser on or before 23 March 2021, provided the offer could not be revoked before 27 March 2021.

[50] See the "Definition of 'new build land'" section of this special report for more detail on what constitutes new build land.

[51] These new rules do not apply for the previous 5-year bright-line test, which applies to properties acquired between 29 March 2018 to 26 March 2021 (inclusive).

Land acquired	Type of land	Bright-line test	Gains taxed if	Settings
On or after 29 March 2018 but <u>before</u> 27 March 2021	Any type of residential land	Previous 5-year bright-line test	Sold within 5 years of bright-line acquisition date	Old main home rules
On or after 27 March 2021	New build land, if certain criteria are met	5-year new build bright-line test	Sold within 5 years of bright-line acquisition date	New main home rules
On or after 27 March 2021	All residential land that doesn't qualify for 5-year new build bright-line test	10-year bright-line test	Sold within 10 years of bright-line acquisition date	New main home rules

Amendments to the bright-line test relating to main homes

Changes to the time apportionment rule for main homes

A person's main home is not taxed under the bright-line test because an exclusion for main homes applies (the main home exclusion). The main home rules determine whether a person qualifies for the main home exclusion. There are effectively two sets of main home rules – the old main home rules and the new main home rules.

The old main home rules apply to land acquired before 27 March 2021. Under the old main home rules, a person could qualify for the main home exclusion where their property was rented out for some of the time they owned it, provided the property was used predominantly as the owner's main home for more than 50 percent of the bright-line period.

The old main home rules apply to land that is subject to the previous 5-year bright-line test. They do not apply for land that is subject to the 10-year bright-line test or the 5-year new build bright-line test (that is, they do not apply to land acquired on or after 27 March 2021).

However, the current changes have only been made to the new main home rules.

The new main home rules only apply to land acquired on or after 27 March 2021. The introduction of the new main home rules ensured that the main home exclusion was still fit for purpose with the extension of the bright-line period to ten years.

Under the new main home rules, the bright-line test no longer applies on an all or nothing basis, but rather it applies only for the period a property is actually used as the owner's main home. The new main home rules require the gain on sale to be apportioned between main home use and non-main home use to ensure only the gain attributable to the non-main home use is taxed (sometimes referred to as the time apportionment rules). There is also a 12-month buffer within which the property can be used other than as the main home without tax implications. The 12-month buffer period can be used multiple times. Periods when the property is not used as a main home that exceed 12 months are taxed.

The 12-month buffer rule has now been amended so that where a person is constructing their main home and construction takes more than 12 months the main home exclusion can still apply, and the person is not subject to the bright-line test. This is provided the time they take to construct the home is reasonable.

New land apportionment rule for non-predominant main homes

A new land apportionment rule for land that is not predominantly used as the main home has also been introduced. This rule applies alongside the new main home rules (including the 12-month buffer) that apply to land acquired on or after 27 March 2021, discussed above.

Previously, the main home exclusion applied where the land was used predominantly for the main home – meaning that more than half the land was used for the main home. This meant that a main home could fall outside the main home exclusion and be subject to tax under the bright-line test if less than half the land was 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, the previous main home exclusion would not apply. The whole gain on the sale of the property would be taxed if the land was sold within the applicable bright-line period, rather than just the gain attributable to the rental properties.

With the bright-line period having been extended significantly, from five years to ten years, these settings are no longer appropriate. A 10-year bright-line period makes it more likely that main homes that make up less than half of the land would be taxed on sale, such as in the scenario above, because the bright-line test applies for a longer period. Therefore, a land apportionment rule has been introduced for land not predominantly used as a main home to ensure the main home portion of the land is not taxed under the bright-line test.

For more information on these changes, see the "Amendments to the bright-line test relating to main homes" section of this special report.

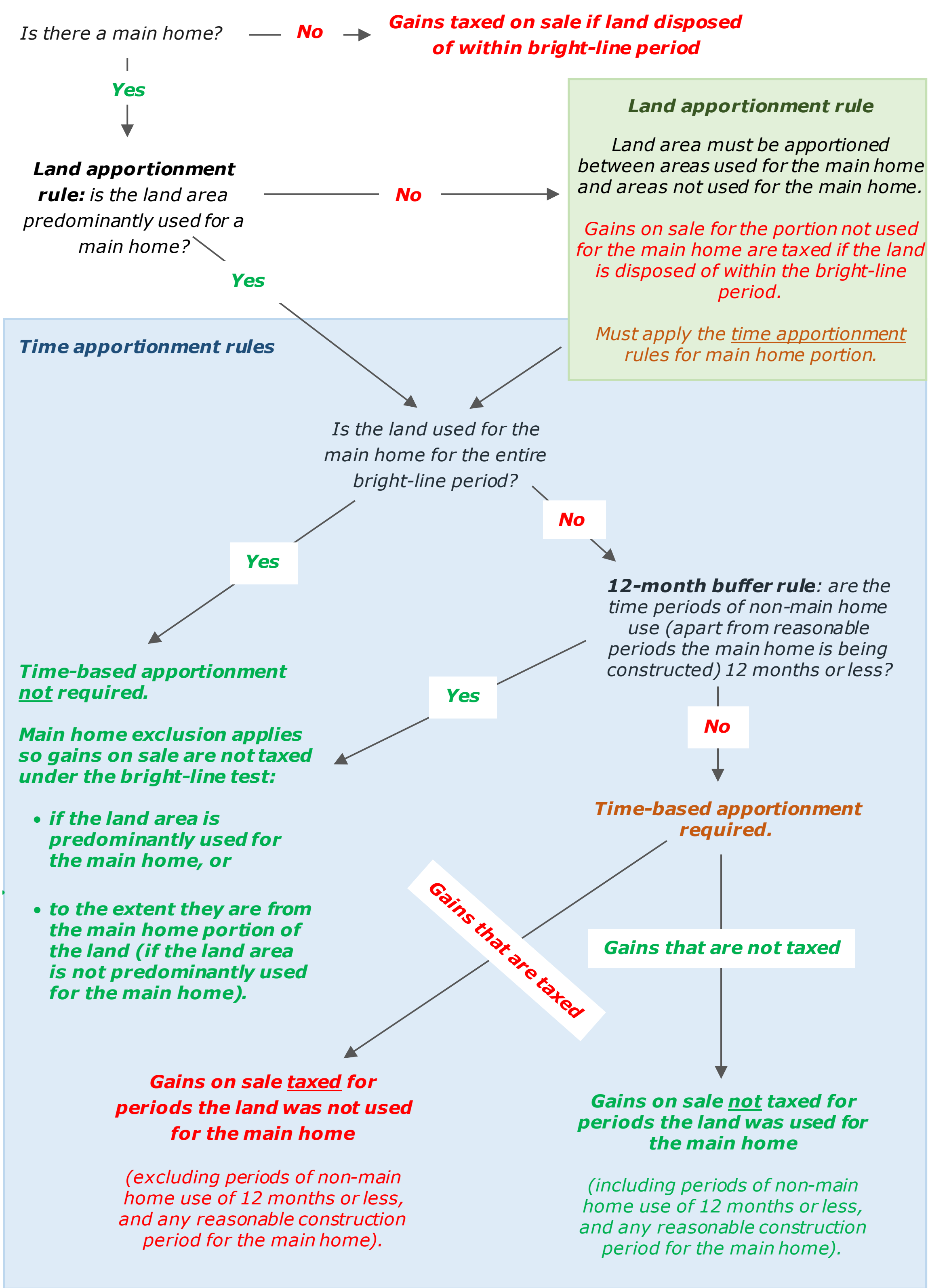
The table and flowchart below summarise the main home rules tests.

Main home rule	Applies to land acquired	Time apportionment	Land apportionment
Old rules	Before 27 March 2021	Does not apply	Does not apply
New rules	On or after 27 March 2021[52]	Applies	Applies if the land is not used predominantly for the main home

[52] But not to residential land acquired on or after 27 March 2021 as a result of an offer made by the purchaser on or before 23 March 2021, provided the offer could not be revoked before 27 March 2021.

Flowchart 10: Main home exclusion – land and time apportionment rules

NOTE: THIS FLOWCHART PRESENTS A HIGH-LEVEL OVERVIEW OF KEY CONCEPTS AND MUST BE READ IN CONJUNCTION WITH THE EXPLANATORY TEXT IN THIS SPECIAL REPORT.



5-year new build bright-line test

Sections CB 6A, CB 16A, DH 5(7) and YA 1 of the Income Tax Act 2007

A 5-year new build bright-line test generally applies to land acquired on or after 27 March 2021 if there is a new build on the land when it is sold. The purpose of the 5-year new build bright-line test is to ensure investment in new housing supply is not negatively impacted by the 10-year bright-line test.

Key features

You should ensure you have read the "Bright-line test changes – background and overview" and "Definition of 'new build land'" sections of this special report before reading this section.

The 5-year new build bright-line test applies to residential land acquired on or after 27 March 2021 if the land:

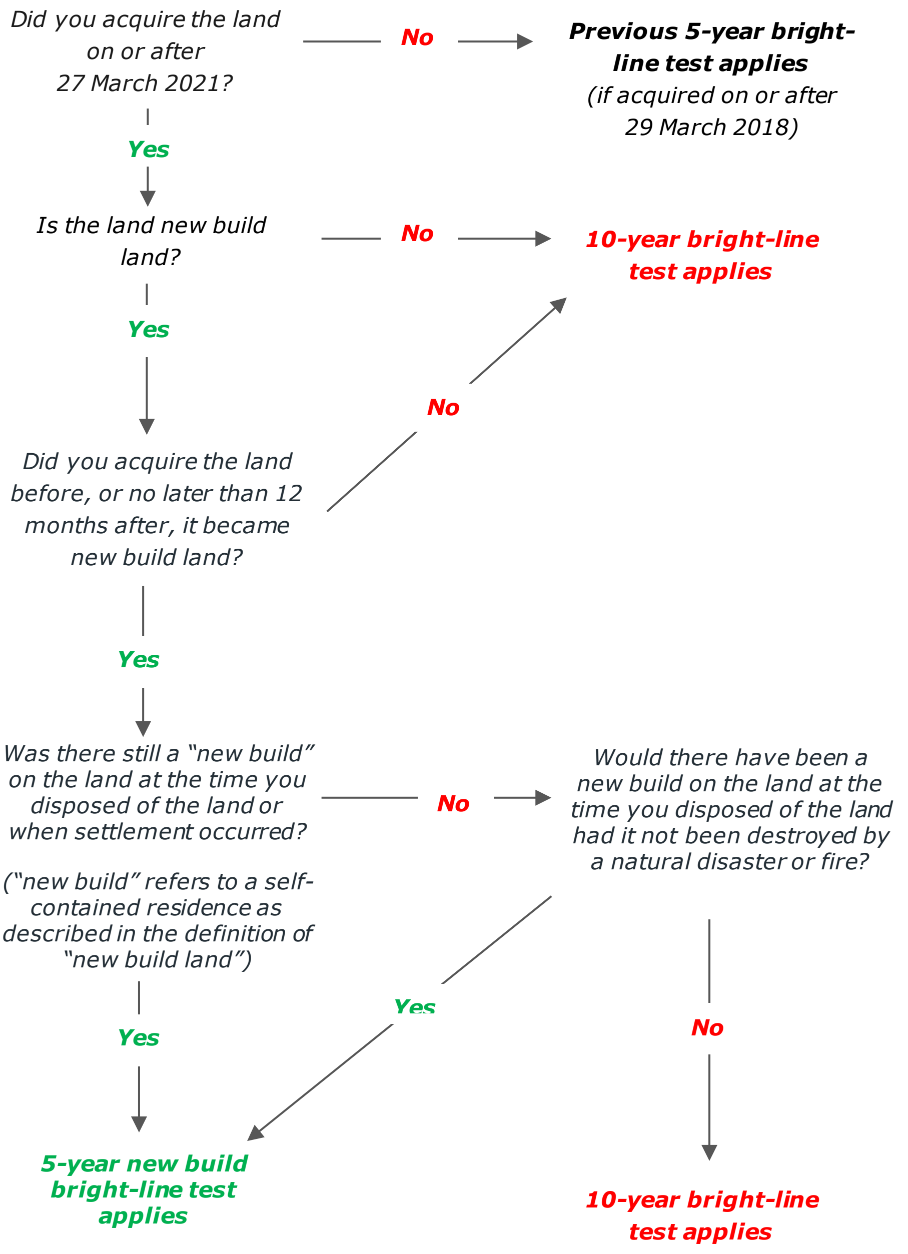
- is new build land (as defined in section DH 5(7)),
- is acquired before, or no later than 12 months after, it became new build land, and
- there is a self-contained residence (new build), as described in the definition of new build land, on the land when it is disposed of or when settlement occurs, unless the new build was destroyed by a natural disaster or fire.

Land to which the 5-year new build bright-line test applies is called "5-year test land" in section CB 6A.

Sometimes only part of the land will satisfy the conditions of the 5-year new build bright-line test – for example, where the land has both a new build and an existing house on it. In these circumstances, a land area test must be applied to determine how much of the land is subject to the 5-year new build bright-line test. Other than the shorter 5-year period, the same settings as those that apply for the 10-year bright-line test apply for the 5-year new build bright-line test.

Flowchart 11: 5-year new build bright-line test

NOTE: THIS FLOWCHART PRESENTS A HIGH-LEVEL OVERVIEW OF KEY CONCEPTS AND MUST BE READ IN CONJUNCTION WITH THE EXPLANATORY TEXT IN THIS SPECIAL REPORT.



Application date

The 5-year new build bright-line test applies to residential land acquired on or after 27 March 2021 that satisfies the requirements of the test.[53]

Detailed analysis

Definition of "new build land"

Generally, "new build land" is defined under section DH 5(7) as land that has had a self-contained residence or abode added to the land, or a place on the land converted to a residence, and the code compliance certificate (CCC) for the residence was issued on or after 27 March 2020.[54]

Acquired no later than 12 months after meeting the new build land definition

To qualify for the 5-year new build bright-line test, a person must acquire[55] the land within 12 months of it becoming "new build land" (section CB 6A(1)(b)(i)). This includes the following situations:

- When a person acquires the land ***after*** it becomes new build land, provided the person acquires the land no later than 12 months after it becomes new build land. Generally, this means that when a person acquires an already constructed new build, the person must acquire the land no later than 12 months after the new build received its CCC.
- When a person already owned the land ***before*** it became new build land. For example, where a new build is constructed on land the person already owns.

[53] But not to residential land acquired on or after 27 March 2021 as a result of an offer made by the purchaser on or before 23 March 2021, provided the offer could not be revoked before 27 March 2021.
[54] For more information, see the "Definition of 'new build land'" section of this special report.
[55] 'Acquire' has the same meaning as for the other existing bright-line tests, and generally means the date a sale and purchase agreement to buy land is entered into.

Example 79: Land acquired no later than 12 months after becoming new build land

Catherine purchases an already constructed new build from a developer in May 2022. The property received its CCC in April 2022, before Catherine bought it. She sells the property to Peter in January 2023 and is taxed under the 5-year new build bright-line test. This is because she has sold the property within five years of acquiring it.

Peter is also subject to the 5-year new build bright-line test. This is because he has acquired the land within 12 months of April 2022, which is when the new build received its CCC.

Peter sells the property in December 2028. As he has sold the property more than 5 years after acquiring it, he would not be subject to tax under the 5-year new build bright-line test.

Fact variation: Peter acquires property in January 2024

If Peter acquires the property in January 2024, instead of January 2023, then the 10-year bright-line test would apply. Peter would not qualify for the 5-year new build bright-line test, because he acquired the land more than 12 months after the new build received its CCC. If he sells the property within 10 years of acquiring it, that is, before January 2034, any gain he makes on sale will be subject to tax under the 10-year bright-line test.

Land can qualify for 5-year new build bright-line test more than once

Where land has met the definition of "new build land" more than 12 months ago (for example, the CCC for a residence on the land was issued 20 months ago), if a person acquires that land, that person will not qualify for the 5-year new build bright-line test. The 10-year bright-line test will apply instead.

However, if that person then adds a new residence to the land, the 5-year new build bright-line test will apply for that person in relation to the portion of the land attributable to that new residence. The 10-year bright-line test continues to apply to the portion of the land attributable to the original residence.

Application to subsequent purchasers

If all the land (that is, including both the existing and new residences) is sold within 12 months of the new residence's CCC being issued, the purchaser will be subject to the 5-year new build bright-line test for the portion of the land attributable to the new residence. The portion of the land attributable to the original residence will be subject to the 10-year bright-line test, as the purchaser has acquired that portion of the land more than 12 months after the original residence received its CCC.

However, if all the land is sold more than 12 months after the CCC for the new residence was issued, none of the land will qualify for the 5-year new build bright-line test for the purchaser. The entire parcel of land will be subject to the 10-year bright-line test.

Example 80: Apportionment where a second new build is added to the land

Gwenda acquired land in 2010 with an existing residence on it ('original residence'). Gwenda adds a second residence to the land that receives its CCC in February 2022 ('new residence'). She then sells the property to Vicki in November 2022. The 5-year new build bright-line and 10-year bright-line tests are not relevant to Gwenda, because she acquired the land before 27 March 2021.

Vicki has acquired the land more than 12 months after the original residence received its CCC, so the 10-year bright-line test will apply to Vicki for the portion of the land attributable to the original residence. However, Vicki has acquired the land within 12 months of the new residence receiving its CCC. Therefore, the 5-year new build bright-line test will apply to the portion of the land attributable to the new residence.

Vicki eventually sells the property in January 2028. As it has been more than five, but less than ten, years since she acquired the property, the gain on sale for the portion of the land attributable to the new residence will not be subject to tax under the 5-year new build bright-line test. However, the gain on sale for the portion attributable to the original residence will be subject to tax under the 10-year bright-line test.

Must have a new build on the land when disposal or settlement occurs

For the 5-year new build bright-line test to apply, there must be a new build on the land at the time the land is disposed of or when the instrument to transfer the land is registered (that is, the date settlement occurs), except where the new build was destroyed by a natural disaster or fire (section CB 6A(1)(b)(iii)). This is because the 5-year new build bright-line test is only intended to apply where there has been an increase in housing supply – if there is no new build on the land at the time the land is disposed of, then the objective of increasing housing supply has not been met. An exception exists where a new build has been destroyed by a natural disaster or fire. This is in recognition of the fact the housing supply was increased but the new build was destroyed through circumstances outside the taxpayer's control.

Example 81: New build must be on land when sold

Daniel acquires bare land in June 2025. A new build is added to the land and receives its CCC in December 2028, from which point the land would satisfy the definition of "new build land". Daniel sells the land in November 2031.

The 5-year new build bright-line test would apply rather than the normal 10-year bright-line test, because Daniel has sold "new build land". Daniel would not be taxed under the 5-year new build bright-line test as more than 5 years have passed since he acquired the land in June 2025.

Fact variation: New build destroyed in natural disaster

Same facts as above, except in March 2029 a flood severely damages Daniel's property and the new build is destroyed. David then sells the bare land in November 2031.

The 5-year new build bright-line will still apply to Daniel's property, as the new build was destroyed by a natural disaster. As more than 5 years have passed since Daniel acquired the land, any gain he makes will not be taxed on sale.

For the 5-year new build bright-line test to apply, it is not sufficient for there to be an agreement in place to construct a new build on the land. As noted above, there must actually be a new build on the land at the time of disposal, unless the natural disaster/fire exception applies. Therefore, land that only qualifies as "new build land" because of section DH 5(7)(c) (which includes land for which there is an agreement to add a self-contained residence) will not qualify for the 5-year new build bright-line test – that paragraph of the definition of "new build land" is only relevant for the interest limitation rules, not the 5-year new build bright-line test.

Example 82: No CCC before sale

Luke purchases bare land in May 2024. He and his brother Liam decide to add a new build to the land. Halfway through the project, Luke and Liam have a falling out. The partially constructed new build cannot get a CCC, as there is still major building work that needs completing. Luke decides he cannot finish construction of the new build on his own and sells the land in July 2030.

The 5-year new build bright-line test will not apply. The land has not satisfied the definition of "new build land" because the new build has not received its CCC by the time Luke disposes of the property. The 10-year bright-line test will apply to tax any gains Luke makes on selling the property.

Disposal within five years

To be subject to tax under the 5-year new build bright-line test, land must be disposed of within 5 years of the bright-line acquisition date (section CB 6A(1)(b)(ii)). In most situations, the bright-line acquisition date will be the date the transfer of the land to the person is registered.

Adding a new build to land after acquisition does not restart the bright-line period from the date the new build is added – the five-year period is still counted from the bright-line acquisition date. If land is disposed of after the 5-year new build bright-line period has passed, then the land will not be taxed under the test.

Example 83: Bright-line period does not restart when new build is added

James signs a sale and purchase agreement for a section in March 2023. Settlement occurs and title is transferred to James on 12 April 2023. James adds a new build to the section and receives a CCC confirming it has been added to the land on 15 June 2025. James sells the property in October 2029.

The bright-line period begins on 12 April 2023 (when title was transferred to James) and not from June 2025 (when the new build receives its CCC). The 5-year new build bright-line test applies to the land because James acquired the land on 12 April 2023, which is after 27 March 2021 and before 15 June 2026 (therefore not later than 12 months after the land met the definition of "new build land"), and there is a completed new build on the land when he sold the property. Therefore, James would only be taxed on the gains on sale under the 5-year new build bright-line test if he sells the property before 12 April 2028 (that is, within 5 years of title for the property transferring to James). Since James sells the land outside that period, the 5-year new build bright-line test would not apply to tax any gains he makes on sale.

Apportionment where only part of the land qualifies

Section CB 6A(2) provides that an amount from disposing of residential land is income to the extent to which the amount is for "10-year test land" or "5-year test land". The use of the words "to the extent" allows for apportionment where all the land disposed of is not 5- or 10-year test land. This applies for land acquired on or after 27 March 2021.

Section CB 6A(1) defines "10-year test land" as residential land to the extent to which, using a land area test, it is not new build land, and it was disposed of within 10 years of the bright-line acquisition date.

"5-year test land" is defined as residential land to the extent to which, using a land area test, it is new build land and:

- the person acquires it within 12 months of it becoming "new build land"
- it is disposed of within 5 years of the bright-line acquisition date, and
- when it is disposed of, it meets the definition of "new build land" under any of sections DH 5(7)(a), (b), (d), (e), or (f), or would have but for destruction caused by a natural disaster or fire.

In the straightforward case of new build land being acquired and sold within 5 years (and satisfying the other requirements mentioned above), the 5-year new build bright-line test applies to tax the entire piece of land.

Example 84: Simple application of 5-year new build bright-line test

Florence buys a section of bare land in July 2021. She constructs a new build on the land, which receives its CCC on 21 October 2022. Florence then sells the land in March 2023 to Fred. As Florence has disposed of the land within five years of acquisition, she will have to pay tax on any gain on sale under the 5-year new build bright-line test.

However, in cases where the land only partially qualifies for the 5-year new build bright-line test (such as where a new build is added to a property that has an existing residence on it), "to the extent" and the reference to a "land area test" mean that:

- The portion of the land with the relevant new build on it is subject to the 5-year new build bright-line test. This includes the land immediately beneath the new build, outdoor areas exclusive to the new build, and a reasonable proportion of shared areas.
- The remaining portion of the land is subject to the 10-year bright-line test.

The "land area test" means that apportionment must be based on the square meterage of the land attributable to the relevant new build and the remaining portion of the land. A valuation-based apportionment method may not be used.

Example 85: Apportionment where a new build and existing residence are on the same title

Charlotte purchases a 600m^2 section of land for $1m in February 2022. There is an original residence on the land, as well as a new build that received its CCC in December 2021. Charlotte rents out both residences.

The land is comprised of the following areas:

- the original residence, which covers 150m^2
- exclusive areas attributable to the original residence, which cover 100m^2
- the new build, which covers 200m^2
- exclusive areas attributable to the new build, which cover 100m^2, and
- a shared driveway (that is available to the occupants of both the original residence and new build) of 50m^2.

Charlotte sells the land in April 2028 for $2.5m and makes a total gain of $1.5m.

Charlotte's calculations under the bright-line tests are as follows:

New build

As Charlotte acquired the land less than 12 months after part of the land became new build land, the portion of the land attributable to the new build is subject to the 5-year new build bright-line test. The portion of the land attributable to the new build is

325m^2 (comprised of the land under the new build, the land exclusively used by the new build, and a half share of the common driveway). This is 54.2% of the total 600m^2 land area.

Tax on sale

Charlotte sells the property more than five years after she first acquired it. Therefore, 54.2% of the gain is not taxed on sale under the bright-line test because the land is taxed outside the 5-year new build bright-line period.

Original residence

The portion of the land attributable to the original residence is subject to the 10-year bright-line test. The original residence makes up 275m^2 of the total land (comprised of the land under the residence, the land exclusively used by the residence, and a half-share of the common driveway). This is 45.8% of the total 600m^2 land area.

Tax on sale

Charlotte is required to pay tax on the following amount of her gain on sale:

($2,500,000 - $1,000,000) x 45.8% = $687,000

At her marginal tax rate of 39%, she must pay tax of $267,930 on her $687,000 taxable gain on sale.

Amendments to the bright-line test relating to main homes

Sections CB 6A, CB 16A, DB 23C and YA 1 of the Income Tax Act 2007.

The bright-line test has been amended to ensure that:

- the existing new main home rules that apply for the 10-year bright-line test also apply for the 5-year new build bright-line test
- a land apportionment rule applies, so that a main home that takes up less than half the land (and therefore cannot benefit from the existing main home exclusion) is not taxed under the bright-line test while it is used as a main home, and
- the main home exclusion applies to the entire construction period of a main home.

Key features

You should ensure you have read the "Bright-line test changes – background and overview" section of this Special Report before reading this section.

Land apportionment rule for main homes

Extension of new main home rules to 5-year new build bright-line test

The changes ensure that the same rules apply for both the 10-year bright-line test and the 5-year new build bright-line test.[56] The two existing new main home rules (also known as the time apportionment rules) that apply for the 10-year bright-line test have been extended to also apply for the 5-year new build bright-line test, and a new land apportionment rule has been introduced to apply to both tests.

The two rules that have been extended to apply to the 5-year new build bright-line test are as follows:

- If more than half the land was used for the main home, and the property was the person's main home for all the ownership period (including days in the 12-month buffer period), the main home exclusion applies.
- If more than half the land was used for the main home, but the main home exclusion does not apply because the property was not the person's main home for the whole ownership period, any gain on sale that relates to periods the land was used as a main home will not be taxed. Only the gain that relates to periods the land was not used as the main home will be taxed.

New land apportionment rule

The new land apportionment rule introduced for both the 5-year new build bright-line test and the 10-year bright-line test applies if:

- the land was used for both a main home and a non-main home, and
- less than half the land was used for the main home (so the usual main home exclusion, which applies where land is predominantly used for a main home, does not apply).

[56] Note that there are different rules for the 5-year bright-line test that applies to land acquired on or after 29 March 2018 but before 27 March 2021.

Under the apportionment rule, only the non-main home portion of the land is taxed under these two bright-line tests. Thus, the main home is not taxed while it is being used as a main home.[57]

A person who builds a second residence on the same land as their main home (for example, a granny flat) continues to benefit from the existing main home exclusion where that second residence takes up less than half the land. The time apportionment rules, which apply when a property is not used as the main home for more than 12 consecutive months, continue to apply regardless of whether the main home takes up more or less than half the land. These rules ensure that tax is paid on any periods of non-main home use that exceed 12 months at a time – for example, while a residence is used as a rental property for more than 12 months.

If land is used for both a main home and business premises (for example, a hair salon and main home on the same land), the existing rules continue to apply:

- If the land is used predominantly as business premises, the bright-line test does not apply.
- If the business premises take up less than half the land, and the existing main home exclusion does not apply, the business premises portion of the land is taxed. For example, this could occur where a parcel of land has a main home that takes up less than half the land, a small business premises that also takes up less than half the land, as well as a rental property. While the business premises and rental property portions of the land are taxed under the bright-line test, the main home portion of the land is not taxed because of the changes set out above.

Test for main home that takes longer than 12 months to construct

The period during which a person constructs a dwelling that they then use as their main home is not subject to the bright-line test, even if it exceeds 12 months, provided the period is reasonable. Whether the period is reasonable is fact specific. However, it is highly likely that the period taken will be considered reasonable in most cases given there is no incentive for a person to delay construction to obtain a longer buffer period, due to the cost and the fact that a main home falls outside the bright-line test anyway.

[57] With the existing exceptions of situations where the main home exclusion has been used twice in the last two years or there is a regular pattern of acquiring and disposing of residential land.

Application date

The changes apply to residential land acquired on or after 27 March 2021.[58] This means the changes apply to the 10-year bright-line test and the 5-year new build bright-line test, but not the previous 5-year bright-line test (which applies to land acquired on or after 29 March 2018 but before 27 March 2021).

Detailed analysis

Land apportionment rule for main homes

The land apportionment rule for main homes has been added to the two formulas that determine the amount of taxable income a person has under the bright-line test — in section CB 6A(8) to apportion income, and in section DB 23C to apportion the deduction that may be claimed.

Income reduction (section CB 6A(8))

Under section CB 6A, the amount a person derives from disposing of residential land within the bright-line period is, prima facie, income. This amount is then adjusted by the quantification provision in section CB 6A(8). The quantification provision in the bright-line test has been amended to include the land apportionment rule. The purpose of the quantification provision is to determine the amount attributable to the use of the property as a main home and then subtract that from the person's income on disposal of the property.

The land apportionment rule is given effect through "exempted non-predominant main home days x main home percentage", which is bolded in the formula below. The rest of the formula below is from the existing time apportionment rules that were introduced in 2021, although the terms in the formula have been renamed so that they are more intuitive.

[58] But not to residential land acquired on or after 27 March 2021 as a result of an offer made by the purchaser on or before 23 March 2021, provided the offer could not be revoked before 27 March 2021.

The amended quantification provision in section CB 6A(8) is as follows:

$$\text{unadjusted income} \times \frac{((\textbf{exempted non-predominant main home days} \times \textbf{main home percentage}) + \text{exempted predominant main home days})}{\text{total days}}$$

The below table explains the key terms used in the formula:

Key terms	Meaning	Further explanation
Unadjusted income ***(s CB 6A(10))***	The full amount of income the person derives from disposing of the land.	This is generally the amount the person receives from selling the property.
Exempted non-predominant main home days ***(s CB 6A(11))***	The sum of: the total number of days in the bright-line period where the land has been used for a dwelling (to some extent, but not predominantly) that was the main home for one or more main home persons[59], and days that are in a period (or periods) equal to or shorter than the exempt main home period limit[60] where the land has not been used for a dwelling that was the main home for one or more main home persons, provided the start and end of the period adjoins either a period of main home use or the start or end of the land's bright-line period, but excluding any exempted predominant main home days	This term covers days where less than half the land has been used as a main home (including days of non-main home use under 12 months). For example, where a person has a house and a granny flat on the same title, and they live in the granny flat.

[59] Main home person means the homeowner, or a beneficiary of a trust in certain circumstances (sections CB 16A(1D) and YA 1).
[60] The exempt main home period limit is 365 days or, where a person constructs a dwelling used as their main home, the length of that period provided it is reasonable (sections CB 16A(1C) and YA 1).

Key terms	Meaning	Further explanation
Main home percentage *(s CB 6A(11B))*	The percentage area of the land that, during the exempted non-predominant main home days, has been used as a main home.	Whether all the land is to be included in the main home percentage will be a question of fact to be determined by considering whether all the land is used for or in connection with the main home. Land that has been used for a dwelling is not limited to the land on which the dwelling is situated or to the surrounding curtilage (like a yard or garden) and can, depending on the facts, include other areas used in connection with or for the benefit of the dwelling.
Exempted predominant main home days *(ss CB 6A(11C) and CB 16A(1B))*	The sum of: The total number of days in the bright-line period where the land has been used predominantly for a dwelling that was the main home for one or more main home persons. Days in a period (or periods) equal to, or shorter than, the exempt main home period limit where the land has not been used predominantly for a dwelling that was the main home for one or more main home persons, but the start and end of the period adjoins either a period of main home use or the start of end of the land's bright-line period.	This definition is the almost same as the definition for "exempted non-predominant main home days". The key difference is that this definition covers where the land has been used predominantly (that is, more than 50%) for a main home.
Total days *(CB 6A(11D))*	The total number of days in the bright-line period.	

The quantification formula only needs to be used if the property is the person's main home for only some of the time it was owned, or if the main home and relevant outdoor areas take up less than half the land (for example, because part of the land is also used for a rental property).

The effect of the formula is to evenly apportion the sale proceeds from the property over the period it is held and over the areas used for different purposes (that is, main home and other purposes), with the result that:

- The amount attributable to the part of the property used for the main home, and to the period for which it was used as the main home, is not income for tax purposes.
- The amount attributable to the part of the property not used for the main home, or to any period of more than 365 consecutive days when the property was not used as the taxpayer's main home, is income for tax purposes.

There is no option to pay tax based on the actual valuations of the property at the start and end of the period the property was not the taxpayer's main home.

The below example illustrates how the formula works for both the existing time apportionment rule and the new land apportionment rule.

Example 86: Apportionment of time and space under the bright-line test

Daniel purchased a property for $750,000. It was transferred to him on 15 June 2021. He sold the property on 28 June 2027 for $1.8 million (2,205 days of ownership). The property is made up of his main home (65% of the land, including outdoor areas) and a minor dwelling (35% of the land, including outdoor areas). He:

- lived in the main home for 656 days
- went overseas for 258 days and rented the main home out while away
- returned to live in the main home for 293 days
- went overseas for 398 days and rented the main home out
- returned from overseas and stayed in the minor dwelling for 400 days (which therefore became his main home during this period), and
- moved out and left the minor dwelling vacant for 200 days before selling.

Daniel's income calculation

The formula in new section CB 6A(8) is:

$$\text{unadjusted income} \times \frac{(\text{(exempted non-predominant main home days} \times \text{main home percentage)} + \text{exempted predominant main home days})}{\text{total days}}$$

Applying the formula to Daniel's facts:

- **Unadjusted amount is $1.8 million.** This is the full amount Daniel sold his property for.
- **Exempted non-predominant main home days is 600.** This is the 400 days Daniel lived in the minor dwelling plus the 200 days it was vacant before he sold it (because the non-main home use is 365 days or less and the start and end of the 200-day period adjoin a period of main home use / the end of the bright-line period).
- **Main home percentage is 35%.** This is the portion of land taken up by the minor dwelling while Daniel lived in it.
- **Exempted predominant main home days is 1,207.** This is the sum of the 656 days Daniel lived in the main home, the 258 days he rented the main home out while he was away (because the non-main home use is 365 days or less and the start and end of the 258-day period adjoin periods of main home use), plus the remaining 293 days Daniel lived in the main home after returning from his first

period overseas. The 398 days Daniel rented out the property while he was overseas a second time do not count as exempted predominant main home days because they exceed 365 days.

- **Total days is 2,205.** This is the total days in the bright-line period.

So, applying the formula to the facts in this example:

$$\$1{,}800{,}000 \times \frac{((600 \times 35\%) + 1207)}{2205} = \$1{,}156{,}735$$

The $1,156,735 is then subtracted from Daniel's sale price to give him total income of **$643,265** under section CB 6A(1) ($1,800,000 – $1,156,735 = $643,265). The discussion and continuation of this example below explains what deduction Daniel can claim for the cost of the land.

Cost of residential land reduced (section DB 23C)

The Income Tax Act 2007 operates on a gross basis, with the income and deduction provisions in different subparts. Therefore, to ensure the correct portion of the gain is taxed under the bright-line test, it is necessary to reduce both the income and deduction that may be claimed.

The quantification provision in section CB 6A(8) reduces the income from the land to the extent it was used as a main home. Section DB 23C reduces the cost base (which is deducted against the sale proceeds).

Section DB 23(1) allows a person a deduction for the acquisition cost of the land and any capital improvements. New section DB 23C(2) reduces the deduction a person can claim under section DB 23 if the new quantification provision in section CB 6A(8) applies.

If the income is reduced under section CB 6A(8) because there was some main home use of the land, then section DB 23C ensures that the amount the person is allowed to deduct is correspondingly reduced to the extent the cost of the land relates to the main home.

The rationale for this is that some of the cost was incurred for a private benefit (that is, main home use) and should not be deductible. This is in line with general tax principles, but the specific reduction calculation makes it clear what can be deducted.

Section DB 23C(2) reduces the amount a person can deduct under section DB 23 as follows:

$$\text{cost} \times \frac{((\text{exempted non-predominant main home days} \times \text{main home percentage}) + \text{exempted predominant main home days})}{\text{total days}}$$

The formula effectively mirrors the formula in section CB 6A(8) but adjusts the cost base (deduction) rather than income base. Where the terms are the same, they have the same meaning in both provisions. "Cost" means the cost of the residential land, which would include the purchase price and any capital improvements.

Example 86 continued: Cost of residential land reduced

This example uses the same facts as the previous example.

Daniel bought his property for $750,000 and sold it for $1.8 million. For the formula in new section DB 23C(2):

- Cost is the $750,000 Daniel paid for the property.
- Exempted non-predominant main home days is 600.
- Main home percentage is 35%.
- Exempted predominant main home days is 1,207.
- Total days is 2,205.

Using the formula in section DB 23C(2) gives the following amount that must be subtracted from the amount Daniel would otherwise have been able to deduct under section DB 23:

$$\$750{,}000 \times \frac{(600 \times 35\%) + 1207}{2205} = \$481{,}973$$

Daniel's deduction under section DB 23, after subtracting the $481,973, would therefore be **$268,027** ($750,000 – $481,973 = $268,027).

Combined impact of changes to sections CB 6A and DB 23C

The combined impact of sections CB 6A and DB 23C ensures the net gain on sale that is taxed excludes amounts attributable to main home use of the land.

Example 86 continued: Combined impact of sections CB 6A, DB 23 and DB 23C

This example uses the same facts as the two previous examples:

- Daniel's **income** under section CB 6A is $643,265.

- Daniel's **deduction** for the cost of the property under section DB 23 (after applying section DB 23C) is $268,027.

His net income from the sale is therefore **$375,238** ($643,265 – $268,027). Daniel's income from other sources is $70,000, so he would pay income tax on his gain as follows:

- At 33% (total income between $70,001 and $180,000): $36,300, being $109,999 of Daniel's gain multiplied by 33%.
- At 39% (remaining total income exceeding $180,000): $103,443, being the remainder of Daniel's gain that was not taxed at 33% ($265,239), multiplied by 39%.

From the sale, Daniel would therefore have tax to pay of **$139,743**.

This example does not include any other deductions that Daniel may be entitled to, for example certain interest expenses or rates and insurance.

Test for main home that takes longer than 12 months to construct

The 12-month buffer rule in section CB 16A has been rewritten to make it more user friendly. The effect of the legislation is unchanged, except for a change to the way the construction period for a main home is treated.

Previously, land on which a main home was constructed would be taxed for some of the ownership period if the construction period took longer than 12 months and the property was sold within the bright-line period. The rewrite of the rule ensures that the buffer period applies for the length of construction, even if it exceeds 12 months, provided the period is reasonable.

The definitions of "exempted predominant main home day" and "exempted non-predominant main home day" in sections CB 6A and CB 16A allow a period of non-main home use to qualify under the definitions, provided the period is equal to or shorter than the "exempt main home period limit".

The "exempt main home period limit" is defined in section CB 16A(1C) as 365 days or, in the case of a period during which a person is constructing their main home, the length of that period, provided it is reasonable.

Example 87: Construction taking a reasonable amount of time

John purchased bare land in April 2021 to construct his main home on the land. Because of the workload at his local council, supply constraints for building materials and a shortage of qualified builders, it took two years before John's house was completed and he finally moved in. He then sold the property two years later.

The two years that John was building his house meet the definition of exempt main home period limit. Whilst two years to construct a house is longer than usual, it was reasonable in the circumstances. The period the house was built meets the definition of exempt predominant main home day, as it meets the definition of exempt main home period limit and John lived in the house after it was built. Therefore, John has no tax to pay under the 5-year new build bright-line test as the main home exclusion applies.

Rollover relief – bright-line test

Sections CB 6A(5B), (5C), (5D), (7), (7B), (7C), (15), CB 6AB, CB 6AC, CB 6AE, CZ 39(5B), (5C), (5D), (6B), (6C), (6D), FC 9B, FC 9C, FC 9D and FM 15(2B) of the Income Tax Act 2007

Rollover relief already available for certain transfers or disposals of residential land under the bright-line test has been extended to provide relief for certain transfers to or from family trusts, look-through companies and partnerships, and within wholly-owned, consolidated groups of companies, as well as for certain transfers of land subject to Te Ture Whenua Māori Act 1993 or made as part of a settlement of a claim under te Tiriti o Waitangi – the Treaty of Waitangi (te Tiriti).

Additional amendments ensure that transfers to effect a change in co-ownership do not reset the start of the bright-line period in certain cases.

Background

The bright-line test provides that when residential land is disposed of within 10 years of the instrument of title being registered under the Land Transfer Act 2017,[61] the income is taxable under section CB 6A. The bright-line test was originally introduced as a two-year test. The two-year bright-line period applied for residential land acquired on or after 1 October 2015 and up to 28 March 2018. A five-year test applies for residential land acquired on or after

[61] In some cases, a different start date may apply.

29 March 2018 and up to 26 March 2021, and the 10-year bright-line test applies to residential land acquired on or after 27 March 2021.

Under current tax rules, when land subject to the bright-line test is gifted or sold below market value, the deemed gross income for the disposal is the market value of the land. This is an integrity measure, but in some circumstances this disposal may not be an appropriate taxing point and it can be justified to apply rollover treatment to ignore the disposal for the purposes of the bright-line test. In other circumstances, it might be appropriate to provide partial relief by limiting the value of the deemed disposal so it is taxed based on the actual amount of consideration provided (rather than the market value of the land). In either situation, the bright-line clock would not reset for the purchaser or recipient (so the bright-line period – assume 10 years – does not start again).

Rollover relief is not an exemption from income tax. In the context of the bright-line test, rollover relief defers the taxing point until a subsequent disposal of the land occurs that does not qualify for rollover relief. To achieve this, rollover relief 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. For the bright-line test, the recipient is deemed to take on the transferor's original date of acquisition along with the transferor's cost base.

Rollover relief ensures the recipient can benefit from the transferor's years of ownership of the residential land to determine whether their disposal of the land is inside or outside the bright-line period.

Previously, only limited rollover relief was available under the bright-line test. As the test was originally introduced as a two-year test, extensive rules providing for rollover relief were not designed. Under the previous settings, rollover relief was only provided for residential land transferred under a relationship agreement and for certain company amalgamations, although full relief was available for inherited residential land. These types of relief continue to be available under the new settings.

Key features

The amendments provide rollover relief for certain transfers or disposals of residential land for the purposes of the bright-line test in section CB 6A. Partial relief is provided when a disposal of residential land is made for more than the transferor's cost of the land. Full rollover relief is provided when a disposal of residential land is made for the transferor's acquisition cost or less.

Relief is provided for some transfers to or from family trusts, look-through companies and partnerships, and for transfers within wholly-owned, consolidated groups of companies.

Specific relief also applies to transfers to trusts constituted under Te Ture Whenua Māori Act 1993 and transfers to land trusts as part of settling claims under te Tiriti.

The amendments primarily ensure the bright-line test is not triggered in certain common situations when there is a legal transfer of residential land, but no change in economic substance. In those situations, the transfer will not create an income tax liability under the bright-line test. The amendments providing partial relief from the bright-line test ensure that, in certain circumstances, the transferor is taxed under the bright-line test based on the actual sale price, rather than the market value of the land, and that the bright-line clock is not reset for the purchaser.

Family trusts

Relief applies to transfers of residential land to or from family trusts, provided that:

- each transferor (in the case of transfers to a trust) or each recipient (in the case of transfers from a trust back to a settlor) of the land is also a beneficiary of the trust
- at least one of those transferors or recipients of the land is also a principal settlor of the trust
- all principal settlors are beneficiaries
- all principal settlors are close family associates (broadly, have a close family connection with one another), and
- each beneficiary is either a close family beneficiary (broadly, a principal settlor, has a close family connection with a principal settlor, is a company controlled by a family member beneficiary, or is a charity registered under the Charities Act 2005) or trustee of another trust with at least one beneficiary that is a close family associate of a beneficiary of the first trust.

For relief to apply when the trustees of a family trust of the type described above transfer the land back to its original settlors, each recipient's proportionate interest in the land has to be the same as in the original settlement of the land on the trust.

Relief is available when residential land is transferred back to the original owner and then settled on a new trust, so rollover relief should also be available for a pure resettlement transaction where the trustees of the trust transfer the land to a new trust. While this is not currently provided for in the new legislation, it is intended that rollover relief for such resettlement transactions should be introduced in the next available tax bill.

Specific rule for Māori family trusts

Different conditions apply for transfers of residential land to a Māori authority (or a person eligible to be a Māori authority) as the trustee of a trust. Relief applies if:

- the land is subject to Te Ture Whenua Māori Act 1993
- the transferors of the land are beneficiaries of the trust, and
- all beneficiaries are either:
  - members of the same iwi or hapū, or
  - descendants of the same tipuna (living or dead).

Similar to the rule for general family trusts, relief is also available when the trustees of a Māori trust of the type described above transfer the residential land back to the settlors of the land on the trust, provided those settlors are beneficiaries. For relief to apply in those circumstances, each recipient's proportionate interest in the land must be the same as in the original settlement.

It is intended that where residential land is directly resettled on a new trust, rollover relief should be available. While this is not currently provided for in the new legislation, it is intended that rollover relief for such resettlement transactions should be introduced in the next available tax bill.

Land that is part of a settlement of a claim under te Tiriti and is transferred to a trust

Relief is provided for transfers of residential land to a trust if the land is part of the settlement of a claim under te Tiriti. This will apply where a post-settlement governance entity transfers residential land that is part of the settlement of a claim under te Tiriti to a trust for the benefit of members of the claimant group, for example, hapū. The requirements for this relief are that the land is:

- subject to Te Ture Whenua Māori Act 1993
- part of the settlement of a claim under te Tiriti, and
- transferred to a trustee of a trust that is a Māori authority, or eligible to be a Māori authority, under section HF 2(3)(e)(i) (that is, on behalf of Māori claimants, the trustee receives and manages assets that are transferred by the Crown as part of the settlement of a claim under te Tiriti).

Transfers to or from look-through companies (LTCs) and partnerships

Relief applies to transfers of residential land to or from LTCs and partnerships. This is intended to apply where each person transferring the land to the LTC or partnership (or acquiring it from the LTC or partnership) has the same ownership interest in the land before and after the transfer.

Transfers for less than market value deemed to be for higher of transferor's cost or sale price

In situations that meet the conditions outlined above, full rollover relief is only available if the transfer is made for an amount of consideration that is less than or equal to the total cost of the residential land to the transferor. Where that is the case, the rollover relief applies to deem the transfer to be at cost (which is generally part of what is meant when "full rollover relief" being available is referred to in this special report).

Partial rollover relief applies if the transfer is for more than the transferor's total cost but less than the market value of the land at the date of the transfer. "Partial relief" means that, instead of deeming the transfer to be at market value (as would be the case under existing section GC 1 if no relief were provided) or deeming it to be at cost (which would be the case if "full rollover relief" were available), the transfer is treated for the purposes of the bright-line test as being for the amount of consideration provided.

Another aspect of rollover relief – whether full or partial – is that the recipient is treated as having the same bright-line acquisition date that the transferor had. This ensures that the transfer does not reset the start date of the bright-line period (the bright-line clock).

Transfers between companies within a consolidated group

Relief also applies to transfers of residential land within a wholly-owned, tax consolidated group of companies. This ensures that the start of the bright-line period is not reset upon the registration of the transfer instrument and is available regardless of the consideration for the transfer.

Remedial amendments to the bright-line test – changes in co-ownership

Remedial amendments ensure that transfers to effect a change in co-ownership do not reset the bright-line clock to the extent they do not change a person's proportional or notional proportional interest in the land. These remedial amendments apply to all transactions involving residential land, not just the new categories of rollover relief discussed in this special report.

Application date

The amendments apply to disposals of residential land occurring on or after 1 April 2022. Relief is available for such a disposal even if the land was originally acquired before the introduction of the bright-line test in 2015.[62]

New sections CB 6A(5B), (5C) and (5D), and CZ 39(5B) and (5C), which ensure that certain transfers to effect a change in co-ownership do not reset the bright-line clock to the extent the respective co-ownership shares remain unchanged, apply from 27 March 2021.

Detailed analysis

Family trusts

Under the current bright-line test, a transfer of residential land on trust (via settlement or sale) constitutes a disposal by the transferor and an acquisition by the trustee of the trust. Depending on the circumstances, this can create an income tax liability under the bright-line test or restart the bright-line clock even if the transferor originally acquired the land before 1 October 2015.[63] New section CB 6AB provides relief when residential land is transferred to or from a family trust on or after 1 April 2022, provided certain conditions are met.

Transfers to family trusts

Section CB 6AB(1) provides that if a trustee holds residential land on a "rollover trust", the bright-line acquisition date for the land, when the trustee disposes of it, is the bright-line acquisition date that the settlor had for the land before they transferred it to the trustee. For transfers to a trust, "rollover trust" is defined in section CB 6AB(5) to mean, at the time of a relevant transfer:

- all relevant transfers to trustees of the trust are by people who are beneficiaries of the trust, at least one of whom is a principal settlor of the trust

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[62] Under the provisions as drafted, the transferor and recipient may be subject to different bright-line tests. However, the intention is that if rollover relief applies, the recipient should be subject to the same bright-line test as the transferor. Officials will recommend an amendment to clarify this at the earliest opportunity.
[63] The original two-year bright-line test applied to residential land acquired on or after 1 October 2015.

- all principal settlors are beneficiaries of the trust
- all principal settlors are close family associates, and
- all beneficiaries are either close family beneficiaries, or the trustees of another trust of which at least one beneficiary is a close family associate of a beneficiary of the trust in question.

"Close family beneficiary" is defined in section CB 6AB(6) to mean, for the relevant trust, a beneficiary that is at least one of the following:

- A principal settlor.
- A close family associate of another beneficiary who is also principal settlor.
- A company in which a 50 percent or more voting interest (or a market value interest of at least 50 percent, if a market value circumstance exists) is owned by a beneficiary that is a close family associate of another beneficiary that is a principal settlor.
- A charity registered under the Charities Act 2005.

Under section CB 6AB(7), two persons are "close family associates" if one or more of the following applies:

- they are within four degrees of blood relationship (paragraph (a))
- they are married, in a civil union, or in a de facto relationship (paragraph (b)), or
- one person is within four degrees of blood relationship to the other person's spouse, civil union partner, or de facto partner (paragraph (c)).

This definition includes relatives by adoption, as section 16(2) of the Adoption Act 1955 deems adopted children to be the natural children of their adoptive parent.
Section CB 6A(7)(c) (the third bullet point above) also extends coverage of the association test to include stepchildren and in-laws.

The rules mirror the existing associated person rules in section YB 4 but with an expansion from two degrees to four degrees of association. This is to account for the fact that many family trusts include a wider range of family members than simply those only two degrees removed.

A non-exhaustive list of some common examples of familial relations that meet the "close family associates" test is as follows (references are to paragraphs in the section CB 6A(7) definition):

- The principal settlor's parents and children (one degree of blood relationship – paragraph(a)).
- The principal settlor's grandchildren, grandparents and siblings (two degrees of blood relationship – paragraph (a)).
- The principal settlor's aunts, uncles, nieces, nephews, great-grandchildren, and great-grandparents (three degrees of blood relationship – paragraph (a)).
- The principal settlor's cousins, great-nieces, great-nephews, and great-great-grandchildren (four degrees of blood relationship – paragraph (a)).
- The principal settlor's spouse or de facto partner (paragraph (b)).
- The principal settlor's stepparents, stepchildren, step-siblings, parents-in-law, brothers-in-law, sisters-in-law, daughters-in-law or sons-in-law (within four degrees of blood relationship to the spouse or de facto partner – paragraph (c)).

Further information on how degrees of association are determined in family situations can be found in IR620.[64]

Example 88: Characteristics of a family trust qualifying as a rollover trust

Joan has no children of her own, but she wants to set up a family trust for the benefit of her nephew, George, and his family. The trust's assets include Joan's house in Auckland, a holiday home in Waihi and some other financial assets. The beneficiaries of the trust are Joan, George, George's de facto partner, Charlotte, their two children, Jack and May, along with George's son, Eli, from a previous relationship. Joan loves animals and has been a long-time volunteer for the SPCA, so she also lists the SPCA as a beneficiary of the trust.

The relationships of the beneficiaries are as follows:

- George: three degrees of blood relationship from Joan
- George's partner, Charlotte: four degrees of blood relationship from Joan
- George's children, Jack, May and Eli: four degrees of blood relationship from Joan
- SPCA: registered charity under the Charities Act 2005

[64] IR620 *A guide to associated persons definitions for income tax purposes*, available at www.ird.govt.nz

All the beneficiaries are close family beneficiaries and Joan's trust qualifies as a rollover trust.

Transfers from family trusts to the original settlors

Where a trust is a rollover trust, section CB 6AB(2) provides for rollover relief if residential land is transferred back by the trustees to the person (the original settlor) that originally transferred the land to the trust. In this situation, the original settlor's bright-line acquisition date for the land is the bright-line acquisition date that the trustee had for the land before they transferred it back to the original settlor.

Where land is settled on a rollover trust on or after 1 April 2022, the combination of sections CB 6AB(1) and (2) mean that an original settlor who receives land back from the trust will have the same bright-line acquisition date they had for the land before it was transferred into the trust. This is because the trustee of the rollover trust will have the bright-line acquisition date the original settlor had before the land was transferred into the trust.

For transfers from the trust, "rollover trust" is defined in section CB 6AB(5) to mean, at the time of a relevant transfer:

- all relevant transfers to original settlors are to people who are beneficiaries of the trust, at least one of whom is a principal settlor of the trust
- all principal settlors are beneficiaries of the trust
- all principal settlors are close family associates, and
- all beneficiaries are either close family beneficiaries, or the trustees of another trust of which at least one beneficiary is a close family associate of a beneficiary of the trust in question.

For section CB 6AB(2) to apply, subsection (3) provides that the residential land transferred back to the original settlor by the trustees of the trust must either be:

- the same land they originally settled, and all other original settlors also get their land back, or
- in part the same land they originally settled if that part and all other transfers back to other original settlors are in the same proportions as in the original settlement on the trust.

In other words, rollover relief is available only where residential land held on a family trust is transferred back to the original owner (or owners) in the same proportions they had before.

Rollover relief is not available where residential land held on a family trust is subsequently transferred or distributed to a different beneficiary (for example, a child). Such transfers or distributions of trust property remain subject to the bright-line test, as would be the case if a person transferred residential land directly to their child.

Transfers to or from different capacity (LTCs, partnerships)

Relief may also apply in certain cases under section CB 6AB when:

- residential land is transferred from an LTC or partnership to a family trust (where land may be settled on the trust by a person in a different capacity to the capacity in which they are a beneficiary), or
- a person receives land back from a trust they settled it on, but in a different capacity to the capacity in which they settled it.

Section CB 6AB(3) provides that, for the purposes of applying subsection (1) (where a person transfers residential land to a trust) or subsection (2) (where an original settlor receives residential land back from a trust), the person may transfer land to, or receive it from, the trust in different capacities. For example, A and B may have settled the land on the trust in their own personal capacities, but they may have it transferred back to themselves in their capacity as shareholders in an LTC.

Transfers of shares in LTCs

Section CB 6AB(8) provides that relief does not apply when shares in an LTC are transferred to a rollover trust, nor when such shares are transferred back to the original settlors.

Determination of transferor's net income and recipient's cost base

If the above requirements are met for either a transfer to or from a rollover trust, new sections FC 9B and FC 9C provide that the transfer is treated as being for the greater of:

- the total cost of the residential land to the transferor, or
- the amount of any consideration provided by the recipient.

This applies for calculating both the transferor's net income arising from the disposal under the bright-line test (see section FC 9B(a) and (b)) and the recipient's cost base and thus their net income arising under the bright-line test from a future disposal of the land (see section FC 9C).

This means that if the amount of consideration for the transfer is less than or equal to the cost of the land to the transferor (in other words, the original owner has not realised a gain), the transfer is deemed to be for the transferor's cost – thus, full rollover relief applies.

If the amount of consideration exceeds the cost of the land to the transferor (in other words, the original owner has realised a gain even if it is not a full market value profit), then only partial relief applies. In this case, the transfer is treated as being for the amount of consideration provided. This overrides existing section GC 1 so that the transfer is not deemed to be for the market value of the land at the time of the transfer. In other words, the transferor is only taxed on the actual profit realised on the sale of the land, and the recipient's cost base is what they paid for the land.

Example 89: Settlement on family trust – full rollover relief applies

Married couple Sunita and Ronald purchase residential land in their own names for $1 million on 9 November 2021. On 20 July 2023 Sunita and Ronald decide to settle the land on a trust with Sunita's sister and her sister's spouse as the trustees. Sunita, Ronald and their children are beneficiaries of the trust. The only property settled on the trust is the residential land and the trustees provide consideration of $1 million (even though, in that intervening period, the market value of the property has increased to $1.2 million). The trustees then sell the residential land for $1.7 million on 31 January 2027.

Sunita and Ronald are both beneficiaries of the trust. Sunita and Ronald are also both principal settlors, given that the trust has no other property and Sunita and Ronald have each made the greatest equal settlements. Sunita and Ronald are associated through marriage, and both non-settlor beneficiaries (the two children) are associated with a principal settlor (in this case, both settlors) within the required four degrees of blood relationship (being within one degree of blood relationship). This means they satisfy the requirements of new section CB 6AB.

Full rollover relief applies, as the consideration paid by the trustees to Ronald and Sunita is equal to the price they originally paid for the property. Sunita and Ronald are not subject to tax under the bright-line test on the disposal of their residential land to the trustees of their family trust on 20 July 2023. This is because they are treated as disposing of the land at cost, which means their net income arising under the bright-line test is zero.

The trustees are deemed to have a bright-line acquisition date of 9 November 2021 for the residential land (being Sunita and Ronald's bright-line acquisition date for the land) and a cost base of $1 million. The trustees' bright-line period ends on 31 January 2027 when the land is sold for $1.7 million. As this is within the 10-year period for the bright-line test (9 November 2021 to 8 November 2031), the sale is subject to income tax under the bright-line test. Ignoring other income tax deductions, the trustees have net bright-line income of $700,000.

Example 90: Disposal to yourself as a trustee of a trust – partial relief applies

Neo acquired residential land on 3 March 2017 for $500,000. On 29 October 2022, Neo settles the residential land on a trust with him and his son, Archie, as beneficiaries of the trust. Neo's outstanding mortgage is $400,000. The trustee provides consideration of $600,000, of which Neo uses $400,000 to discharge his outstanding mortgage.

Neo is subject to the two-year bright-line test for the land.[65] The settlement on the trust is a disposal, but there is no tax liability under the bright-line test because Neo held the land for more than two years.

Partial relief applies to ensure the bright-line clock is not restarted, meaning the trustee takes on Neo's bright-line acquisition date of 3 March 2017 but not Neo's acquisition cost of $500,000. The trustee's cost base is instead the amount of consideration it provided, being $600,000.

Example 91: Transfer from family trust to LTC – partial relief applies

Melissa owns 100 percent of the shares in Mel Co, a look-through company. Melissa is also the principal settlor and a beneficiary of the Melissa Family Trust. All the other beneficiaries of the Melissa Family Trust, aside from her husband, Dan, are associated with Melissa within four degrees of blood relationship, being her parents and her and Dan's children.

[65] The two-year test applied to residential land acquired between 1 October 2015 and 28 March 2018.

Melissa purchased an investment property in 2012 for $250,000 and sold it to Mel Co the following year on 6 April 2013 for $275,000.

In October 2022, Mel Co sells the property to the Melissa Family Trust for $700,000. Melissa does not pay tax under the bright-line test in her capacity as shareholder of Mel Co, as the land was acquired by the company before the introduction of the original two-year bright-line test.

Partial relief applies to the transfer of the property from Mel Co to the Melissa Family Trust. This means that the transfer does not reset the start of the bright-line period for the Melissa Family Trust.

Application of land-rich trust anti-avoidance rule

After a transfer of residential land that qualifies for relief is made to a trust, if new beneficiaries are added with the purpose of defeating the bright-line test, the land-rich trust anti-avoidance rule in existing section GB 53 applies to reverse the relief by deeming the recipient to have disposed of the land at market value.

Resettlements of trusts

It is intended that relief should be available for trust resettlements when the trustees of a trust transfer residential land to the trustees of another trust, provided that a principal settlor of the new trust is also a principal settlor of the first trust and the new trust satisfies all the requirements of section CB 6AB(5) in relation to its beneficiaries. However, the current legislation does not permit a direct resettlement to qualify for relief, unless the trustee resettling the property is a beneficiary of the new trust. It is intended that an amendment should be included in the next available tax bill.

Disposals from trusts to beneficiaries

The relief provided by new section CB 6AB does not cover disposals from trustees to beneficiaries that are not also settlors. Disposals of residential land from the trustee to a beneficiary within the relevant bright-line period for the trustee may still be subject to the bright-line test and may produce income for the trustee.

Māori family trust rule

Rollover relief is provided for transfers of residential land on or after 1 April 2022 that is subject to Te Ture Whenua Māori Act 1993 in certain situations. This recognises that land subject to Te Ture Whenua Māori Act 1993 has alienation restrictions that lead to interests in land being passed from generation to generation. These interests are often fragmented and can result in a large number of owners all belonging to the same iwi or hapū or who are all descendants of the same tipuna.

Transfers to Māori family trusts

New section CB 6AC(1) applies when a Māori trustee holds residential land subject to Te Ture Whenua Māori Act 1993 on a Māori rollover trust. For transfers to a trust, "Māori rollover trust" is defined in section CB 6AC(4) to mean, at the time of a relevant transfer:

- all relevant transfers to the trustees of the trust are by people who are beneficiaries of the trust
- all beneficiaries of the trust are either members of the same iwi or hapū, or descendants of the same tipuna (living or dead), and
- the land is subject to Te Ture Whenua Māori Act 1993.

Section CB 6AC(5) defines "Māori trustee" as a trustee of a trust that is either a Māori authority or eligible to elect to be a Māori authority under existing section HF 2(3)(e)(i).

If the above requirements are satisfied, section CB 6AC(1) provides that the Māori trustee's bright-line acquisition date for the land is the bright-line acquisition date that the settlor had for the land before they transferred it to the Māori trustee.

Transfers from Māori family trusts to the original settlors of the trust

Section CB 6AB(2) applies if a person (referred to here as the "original transferor", although the legislation uses the term "original settlor") holds residential land that was transferred back to them from a trustee of a Māori rollover trust that was originally settled by that person. For transfers from a trust, a "Māori rollover trust" is defined to mean, at the time of a transfer to an original transferor:

- all relevant transfers to the original transferors are to people who are beneficiaries of the trust
- all beneficiaries of the trust are either members of the same iwi or hapū or descendants of the same tipuna, and

- the land is subject to Te Ture Whenua Māori Act 1993.

For section CB 6AC(2) to apply, subsection (3) provides that the land transferred back to the original transferor by the trustees of the trust must either be:

- the same land they originally settled on the trust, and all other original transferors also get their land back, or
- in part the same land they originally settled on the trust if that part and all other transfers back to other original transferors are in the same proportions as in the original settlement.

If the above requirements are satisfied, section CB 6AC(2) provides that the original transferor's bright-line acquisition date for the land is the bright-line acquisition date that the Māori trustee had for the land before they transferred it back to the original transferor.

Example 92: Transfer from trustee of Māori family trust back to the settlors of the trust

Before August 2010, John and several members of his extended whānau, who are all members of the same iwi, held interests in a parcel of residential land subject to Te Ture Whenua Māori Act 1993. In August 2010, John and members of his whānau sold their interests in the land to a trust that was settled by John and his sister, Mere, for $5 million. John, Mere and the rest of the whānau that held interests in the land were at this time beneficiaries of the trust (and still are).

On 28 May 2022, the trustees of the trust sell the interests in the land back to members of the whānau for the $5 million the trustees originally paid for the land. The market value of the land at this time is $10 million.

In the absence of relief, John, Mere and the rest of the whānau who purchased their interests in the land back from the trust would have a bright-line acquisition date of 28 May 2022. However, because the transfer was made at cost, rollover relief applies. This means that the whānau who purchased their interests back have a deemed bright-line acquisition date of August 2010, being the transferors' bright-line acquisition date (that is, when the land was transferred to the trustees of the trust), with a total cost base in the land of $5 million (being the total cost of the interests in the land to the trustees). In other words, the bright-line clock is not reset for John and Mere and their fellow interest holders who repurchased their interests in May 2022. As their bright-line acquisition date is August 2010, a future disposal by the interest holders will not be subject to the bright-line test.

Transfers to or from different capacity (LTCs, partnerships)

Relief may also apply in certain cases under section CB 6AC when:

- residential land is transferred from an LTC or partnership to a Māori rollover trust (where land may be settled on the trust in a different capacity to the capacity in which they are a beneficiary), or
- a person receives land back from a Māori rollover trust in a different capacity to the capacity in which they settled it.

Section CB 6AC(3) provides that, for the purposes of applying subsection (1) (where a person transfers residential land to a Māori rollover trust) or subsection (2) (where an original transferor receives residential land back from a Māori rollover trust), the person may transfer land to, or receive it from, the trust in different capacities. For example, A and B may have settled the land on the trust in their own personal capacities, but they may have it transferred back to them as partners in a partnership.

Determination of transferor's net income and recipient's cost base

If the above requirements are met for either a transfer to or from a Māori rollover trust, new sections FC 9B and FC 9C provide that the transfer is treated as being for the greater of

- the total cost of the residential land to the transferor and
- the amount of any consideration provided by the recipient.

This applies for calculating both the transferor's net income arising from the disposal under the bright-line test (see section FC 9B(d) and (e)) and the recipient's cost base and thus their net income arising under the bright-line test from a future disposal of the land (see section FC 9C).

This means that if the amount of consideration is less than or equal to what the transferor originally paid (in other words, the original owner has not realised a gain), the transfer is deemed to be for the transferor's cost – thus, full rollover relief applies.

If the amount of consideration exceeds the cost of the land to the transferor (that is, the transferor has realised a gain, even if it is not a full market value profit), then only partial relief applies. In this case, the transfer is treated as being for the amount of consideration provided. In other words, the transferor is only taxed on the actual profit realised on the sale of the land to the recipient, and the recipient's cost base is what they paid for the land.

Resettlements of Māori family trusts

It is intended that rollover relief should be available when residential land that is subject to Te Ture Whenua Māori Act 1993 is resettled on another family trust, provided certain conditions are met. That is, when the trustees of the trust transfer the property to the trustees of another trust that is also a Māori authority, or eligible to be one, provided the two trusts have a settlor in common and the beneficiaries of the new trust are all members of the same iwi or hapū, or descendants of the same tipuna. However, the current legislation does not permit a direct resettlement to qualify for rollover relief unless the trustee resettling the property is also a beneficiary of the new trust. It is intended that an amendment should be included in the next available tax bill.

Disposals from trusts to beneficiaries

Similar to section CB 6AB for general family trusts, the relief provided by new section CB 6AC for transfers to or from certain Māori trusts does not cover disposals from trustees to beneficiaries that are not also settlors. Disposals of residential land from the trustee to a beneficiary within the relevant bright-line period for the trustee may still be subject to the bright-line test and may produce income to the trustee.

Transfers of residential land as part of a settlement under te Tiriti

Settlements of claims under te Tiriti can be a multi-stage process. The Crown will transfer Treaty settlement property to a single governance entity (post-settlement governance entity or PSGE) that may act on behalf of several groups, for example, different hapū, or as a collective for a number of iwi groups. The PSGE will then transfer settlement assets to different members of the claimant group as required under the deed of settlement or settlement legislation.

This transfer from the PSGE to a member of the claimant group could be subject to income tax under the bright-line test for the PSGE. It could also start the bright-line clock for the member to whom the residential land has been transferred. The transfer of residential land from the PSGE to a claimant group member was less likely to trigger the bright-line test under the previous two-year and five-year tests. However, with the extension of the test to ten years, this could become an impediment for iwi to transact efficiently with settlement assets involving residential land.

New section CB 6AE applies when residential land that is subject to Te Ture Whenua Māori Act 1993 and is part of the settlement of a claim under te Tiriti is transferred to a trustee of a trust who:

- is a Māori authority, or is eligible to be a Māori authority, and
- on behalf of Māori claimants, receives and manages assets that are transferred by the Crown as part of the settlement of a claim under te Tiriti, in accordance with the requirements of existing section HF 2(3)(e)(i).

This is to provide rollover relief for the transfer of Treaty settlement residential land from the PSGE to a member of the claimant group, for example, hapū.

New section CB 6AE(2) provides that the recipient trustee has the transferor's acquisition date.

Determination of transferor's net income and recipient's cost base

If the above requirements are met for the transfer of Treaty settlement residential land, new section FC 9D sets out that the recipient trustee is deemed for the purposes of the bright-line test to have acquired the land for its market value at the time the land was transferred by the Crown. It may not be feasible to determine the market value at the exact time of the Treaty settlement – a reasonable estimate shortly thereafter (for example, determined for insurance purposes) would be acceptable.

Section FC 9B(f) provides that the transferor (the PSGE) is treated as disposing of the land for the greater of its cost to the PSGE or the amount of consideration received (if any) from the member of the claimant group to whom they transfer the land.

Transfers by or to persons in their capacity as look-through company owners or partners in a partnership

Shareholders in LTCs are treated as directly holding the LTCs' assets, deriving income, and incurring expenses in accordance with their shareholding percentage. In effect, LTCs are transparent for tax purposes, which means that the income tax consequences for someone who holds residential land through an LTC are generally the same as for someone who holds residential land directly. Nonetheless, the process of transferring residential land from an individual shareholder into the LTC (or vice versa) currently constitutes a bright-line disposal and acquisition.

Partnerships are also transparent for tax purposes. Equally, the process of transferring residential land from an individual partner to the partnership (or vice versa) constitutes a bright-line disposal and acquisition.

Relief applies under new section CB 6AB(4) if a person transfers residential land to themselves in a different capacity (such as a shareholder in an LTC or a partner in a partnership) and there is no intervening transfer to a third party. The section provides that the person's bright-line acquisition date for the land when they ultimately dispose of it to a third party is the bright-line acquisition date they first had for the land.

This is intended to apply to transfers of residential land to or from LTCs and partnerships where each person transferring the land to the LTC or partnership (or acquiring it from the LTC or partnership) has the same ownership interest in the land before and after the transfer. It is also intended to apply when residential land is transferred from an LTC to another LTC with identical shareholding (meaning that the two LTCs have the exact same owners who each hold the exact same proportion of shares in the second LTC as they hold in the first LTC).

Determination of transferor's net income and recipient's cost base

If the above requirements are met for a person's transfer of residential land to themselves in a different capacity, new sections FC 9B and FC 9C provide that the transfer is treated as being for the greater of:

- the total cost of the residential land to the transferor, and
- the amount of any consideration provided by the recipient.

This applies for calculating both the transferor's net income arising from the disposal under the bright-line test (see section FC 9B(c)) and the recipient's cost base and thus their net income arising under the bright-line test from a future disposal of the land (see section FC 9C).

This means that if the amount of consideration is less than or equal to the cost of the land to the transferor (or in other words, the original owner has not realised a gain), the transfer is deemed to be for the transferor's cost – thus, full rollover relief applies.

If the amount of consideration exceeds the cost of the land to the transferor (that is, a partial gain has been realised, even if it is not a full market value profit), then only partial relief applies. In this case, the transfer is treated as being for the amount of consideration provided. In other words, the transferor is only taxed on the actual profit realised on the sale of the land, and the recipient's cost base is what they paid for the land.

Transfers between companies within a wholly-owned tax consolidated group

An amendment provides rollover relief for transfers of residential land within a wholly-owned group of companies that is a consolidated group under subpart FM. New section FM 15(2B) provides that the recipient company (company B) is treated as having the same bright-line acquisition date for that transferred land as the transferor company (company A). This ensures that the transfer to company B does not reset the bright-line clock.

The restriction of relief to tax-consolidated groups effectively limits the rollover relief to New Zealand resident companies, as non-residents cannot be part of a consolidated group. Similar to the rollover rule for company amalgamations, this ensures that relief is only available on the condition that the property remains within the New Zealand tax base.

Example 93: Transfer within consolidated group

First Co and Second Co are companies that are both members of the same wholly-owned group of companies, of which all the members are New Zealand resident companies. The group is a consolidated group under subpart FM of the Income Tax Act 2007.

First Co acquired residential rental property in the form of an apartment complex in central Hamilton on 12 January 2019 for $15 million. On 23 May 2022, First Co transfers the property to Second Co for $20 million.

Under the consolidation rules, income does not arise to First Co under the bright-line test. However, in the absence of relief, the bright-line clock would reset on the transfer of the property to Second Co.

Relief applies to the transfer, meaning that Second Co. is treated as having a bright-line acquisition date for the property of 12 January 2019.

Start of bright-line period when effecting a change in co-ownership

Under New Zealand law, it is possible for a person to transfer land to themselves by changing the form of co-ownership of the land (for example, changing from holding land as tenants in common to holding it as joint tenants), or by transferring it from co-ownership to sole ownership (or vice versa).

Changing the form of co-ownership

While the registration of a transfer instrument to effect a change in the **form** of co-ownership of land should not be considered a disposal for the bright-line test, registration of a transfer instrument under the Land Transfer Act 2017 sets the start date of the bright-line period.[66] As such, a question arose as to whether the registration of a transfer instrument to change the form of co-ownership of a parcel of land would reset the bright-line "clock", meaning the bright-line period would start again from that point.

New sections CB 6A(5B) and (5C) clarify that, to the extent to which the economic ownership of the land has not changed, the bright-line clock is not reset when a transfer instrument is registered to effect a change in the form of co-ownership of land.

Section CB 6A(5B) applies when a joint tenancy is converted to a tenancy in common. The section provides that, to the extent to which residential land is held as a tenant in common in a share equal to all the other joint owners and to the extent that it was previously held under a joint tenancy with each of the same joint owners holding equal nominal shares, the bright-line acquisition date is the date the joint tenancy was acquired.

Section CB 6A(5C) applies in the reverse situation when a tenancy in common is converted to a joint tenancy. It provides that, to the extent to which residential land is held under a joint tenancy with each of the joint owners holding equal nominal shares and to the extent that it was previously held under a tenancy in common with all the same joint owners holding equal shares, the bright-line acquisition date is the date the tenancy in common in equal shares was acquired.

Example 94: Change from a joint tenancy to a tenancy in common

Tony and Greta started a relationship in 2015. Both have children from previous relationships. In 2019, Tony and Greta purchased a rental property together as joint tenants. Two years later, they decide that in the event of one of them dying, they want to financially assist their children, so want the share of the partner who dies to go to that partner's children. They submitted a land transfer, which LINZ registered in June 2021, to change their ownership of the property from a joint tenancy to a tenancy in common (50:50).

For the bright-line test to apply, there needs to have been a disposal of residential land by Tony and/or Greta. In this case, there has not been a disposal of land by either of them.

[66] For further information, see draft interpretation statement PUB00411: "Income tax – application of the land sale rules to changes to co-ownership, subdivisions, and changes of trustees", published on 28 September 2021, available at https://www.taxtechnical.ird.govt.nz/consultations/draft-items/pub00411

Tony and Greta own the same land (the estate in fee simple) before and after the transfer. Before the transfer, they each had an interest in the whole of the property, and a notional equal separate share (that is, 50 percent) that they had the right to sever during their lifetime. After the transfer, they each still have an interest in the whole of the property, and they each now have a present entitlement to a 50 percent share. No land has passed from one party to another.

The bright-line clock is **not** restarted in June 2021 when LINZ registered the transfer to change the form of co-ownership of the property. Tony and Greta's bright-line period still starts on the date in 2019 when the property was originally transferred to Tony and Greta.

Changes in co-ownership proportions

When a share in residential land is disposed of, the disposal of that share may be subject to tax under the bright-line test. The bright-line clock should reset only for the ownership share that has changed hands (despite the fact the registration of the transfer instrument may effect a transfer of the whole of the land from the parties to themselves in different proportions). For example, if co-ownership shares held by two people change from 50:50 to 25:75, the bright-line clock should reset only for the 25 percent share transferred.

Inland Revenue recently published a draft interpretation statement to clarify the treatment of such arrangements (see PUB00411: Income tax – application of the land sale rules to changes to co-ownership, subdivisions, and changes of trustees).[67] The draft interpretation statement noted that the registration of an instrument of transfer under the Land Transfer Act 2017 resulted in the start date of the bright-line period for all the land being reset. This meant the bright-line clock for the portion of land *not* disposed of was reset on each disposal of a part share, in addition to the portion that was disposed of.

New section CB 6A(5D) clarifies that the bright-line clock is reset only for the newly acquired share when there is a change in ownership proportions. The section applies when a transfer of residential land that is co-owned by two or more persons results in a change in co-ownership proportions (but not necessarily in the *form* of co-ownership), or when ownership of residential land changes from sole ownership to a form of co-ownership, or vice versa. It provides that, to the extent to which land is either:

[67] Available at https://www.taxtechnical.ird.govt.nz/consultations/draft-items/expired-items/pub00411

- transferred *by* a person and, immediately before the transfer, the land was part of other land (referred to as "pre-existing land") that a person owned, or
- transferred *to* a person and, after the transfer, the land merges with other land that the person owns (also referred to as "pre-existing land"),

the instrument of transfer for that transfer is treated as not being for the pre-existing land.

As outlined above, sections CB 6A(5B) and (5C) respectively apply when the form of co-ownership changes from joint tenants to tenants in common and vice versa. Both these sections still apply in the situation when there is a change in co-ownership proportions that occurs simultaneously with the change in the form of co-ownership. This means that the bright-line clock is reset *only to the extent to which* there is a change in co-ownership proportions – the same result as in the case where only the co-ownership proportions change and not the form of co-ownership.

Example 95: Change of the proportional share of co-owners who are tenants in common

In July 2018, Sarah and Hans bought a rental property as tenants in common, Sarah as to 50 percent, Hans as to 50 percent. Sarah's financial position changes in 2020 and so she asks Hans if he is interested in buying out part of her share of the property. He is keen to do this, so he buys half of Sarah's 50 percent interest at market value. LINZ registers the transfer in December 2020, and the register shows that the land is now held by Sarah as to 25 percent, and Hans as to 75 percent. This means that, for the purposes of the bright-line test, Sarah has disposed of a 25 percent interest in the land. The amount that Sarah sold the 25 percent interest to Hans for is income to Sarah under the bright-line test, as the disposal was within the relevant bright-line period (five years). Sarah can deduct half the amount she paid for her original 50 percent share of the property, because she has sold half of her original share.

Hans' bright-line clock is **not** restarted in December 2020 in relation to his original 50 percent share, nor is Sarah's in relation to the 25 percent share she has retained. However, the bright-line clock **does** restart for the 25 percent share transferred by Sarah to Hans, with Hans having a December 2020 bright-line acquisition date in relation to that 25 percent share.

Amendment to definition of "dwelling"

Section YA 1 of the Income Tax 2007

The definition of "dwelling" in section YA 1 of the Income Tax Act 2007 has been amended to replace the word "boardinghouse" with a new defined term, "boarding establishment".

Background

The definition of "dwelling" previously included an exclusion for a "boardinghouse". However, a "boardinghouse" was not defined in the Income Tax Act 2007, and it ultimately depended on the facts and circumstances. This could make it difficult for taxpayers to ascertain whether they were subject to the bright-line test or residential rental loss ring-fencing rules without seeking professional advice.

The new term, "boarding establishment", has been introduced to provide clarity to commercial boardinghouse operators and to minimise potential confusion for landlords who may own a "boarding house" under the terms of the Residential Tenancies Act 1986. This is also relevant for the interest limitation rules in new subpart DH of the Income Tax Act 2007.

The definition of "dwelling" has therefore been updated to refer to a "boarding establishment" instead of a "boardinghouse" to improve clarity and better target the exclusions from a "dwelling" towards commercial-scale accommodation.

See the "Excepted residential land – schedule 15" section of this special report for more information.

Key features

The definition of "dwelling" given in section YA 1 of the Income Tax 2007 has been amended to refer to a "boarding establishment" instead of a "boardinghouse". "Boarding establishment" is a new term also defined in section YA 1.

A "boarding establishment" is defined as premises that:

- are used in a business of supplying accommodation
- are managed by the business
- consist of at least ten boarding rooms that are not self-contained (that is, they do not contain all the necessary features for living, such as a full kitchen or bathroom), and

- include shared living facilities (which provide the necessary features for living not delivered in the residents' boarding rooms) that are available to all residents.

All these requirements must be satisfied for premises to satisfy the "boarding establishment" definition.

Example 96: Property rented out on a room-by-room basis

Gordon owns a six-bedroom villa in central Auckland that he previously rented out on a single tenancy contract. Gordon decides it is better for him and more convenient for the tenants to rent the house on a room-by-room basis.

Each occupant signs a contract for exclusive use of their individual room and shared use of common areas, like the lounge, kitchen and two bathrooms. Under the Residential Tenancies Act 1986, the bedrooms are boarding rooms, and the house is a boarding house.

Gordon's property is not a boarding establishment. Because it has fewer than ten boarding rooms that are not self-contained, there is no need to consider whether it satisfies the other limbs of the definition.

Therefore, Gordon's property is not excluded from being a "dwelling". This means the property is subject to the residential rental loss ring-fencing rules in subpart EL, and Gordon will not be permitted to offset excess deductions against his non-property income. Gordon will also be subject to income tax under the bright-line test in section CB 6A if he sells the property within the relevant bright-line period.

Management by the business is intended to encompass a range of scenarios, including, for example, where a manager lives on-site and has a permanent office, or where someone travels between multiple establishments operated by the business across different locations in a city.

Premises refers to a single site or location, although the relevant facilities may be in multiple buildings on the same site. Buildings located on different pieces of land do not satisfy the requirements, even if the sections are adjacent.

A taxpayer might operate several establishments at different locations. Each location needs to satisfy the "boarding establishment" requirements to be considered excepted residential land. This means that a taxpayer could have multiple boarding establishments for the purposes of the dwelling definition.

Provided the establishment contains at least ten boarding rooms that are not self-contained, other boarding or cabin-style rooms on the same site would form part of the "boarding establishment" and therefore be excluded from the term "dwelling".

Example 97: Boarding establishment

Carl and Emily own C&E Boarding Lodge, a commercial establishment in New Plymouth. C&E Boarding Lodge consists of

- 12 rooms that are not self-contained, with no additional private facilities
- a further six rooms with individual ensuites, and
- six pre-fab cabins with basic bathroom and kitchen facilities.

Occupants sign the same contract, regardless of the type of room, and all occupants have access to shared living facilities, including communal lounges, a commercial-sized kitchen, bathrooms and a coin-operated laundry. Electricity and gas are included in the weekly rent.

Occupants are expected be neat and tidy, although C&E Boarding Lodge cleans and maintains the communal areas and ensures that furnishings in the boarding rooms are in reasonable working order.

C&E Boarding Lodge qualifies as a "boarding establishment" and is therefore excluded from the definition of "dwelling" and not subject to the bright-line test or residential rental loss ring-fencing rules.

However, the premises must still have at least ten boarding rooms that are not self-contained. If there are fewer than ten rooms that are not self-contained, the balance required cannot be satisfied by other rooms.

Example 98: Fewer than ten boarding rooms that are not self-contained

Ivy owns "City View Lodge" in Auckland, which consists of a large house and some self-contained studio units at the back of the section. There are:

- six boarding rooms that are not self-contained, with no additional private facilities, and
- four self-contained studio units with basic bathroom and kitchen facilities.

Occupants sign the same contract, regardless of the type of room, and all occupants have access to shared living facilities in the main house, including a communal lounge, a kitchen, bathrooms and a laundry. Electricity and gas are included in the weekly rent.

City View Lodge does not qualify as a "boarding establishment", because even though it has a total of ten rooms for accommodation, only six satisfy the requirement that they are not self-contained. It is therefore a "dwelling".

Application date

The amendment to the definition of "dwelling" applies for the 2022–23 and later income years.

Administration

Guidance and tools

The new rules largely apply from 1 October 2021. This means that residential rental property owners, tax agents and third parties will have to consider and, if relevant to their circumstances, apply the new interest limitation and bright-line rules from the 2022 income tax return.

Inland Revenue has provided guidance and tools to help taxpayers and others assess whether the interest limitation and bright-line rules apply to their circumstances and to help them comply with the new rules. The guidance and tools can be accessed through Inland Revenue's website at https://www.ird.govt.nz/property/renting-out-residential-property

Tools available include:

- an updated property tax decision tree https://myir.ird.govt.nz/eservices/home/?link=clcproptree
- an online guided help tool "Can I claim interest on my residential rental property?"
- a property interest-phasing calculator, and
- a new build apportionment calculator.

Filing income tax returns

To support the administration and integrity of the new rules, additional information is required in affected taxpayers' income tax returns about the total interest on residential rental property and the interest expense claimed for residential rental property, as well as any reason(s) for the interest expense claimed (a series of tick boxes).

Where relevant, updated income tax return guides reflecting the interest limitation and bright-line changes will be available from April 2022. In addition, the following Inland Revenue guides have been updated or created with guidance on the new rules and will be available from April 2022:

- IR264 Rental income
- IR314 I have bought and sold a property at a profit. Do I have tax to pay?
- IR361 Tax and your property transactions
- IR1021 Tax rules for holiday homes
- IR1095 Deducting residential land withholding tax (RLWT)
- IR1227 Bright-line property tax (new guide)

Further information

About this document

Special reports are published shortly after new legislation is enacted or Orders in Council are made to help affected taxpayers and their advisors understand the consequences of the changes. These are published in advance of an article in the *Tax Information Bulletin*.