

Ring-fencing rental losses

An officials' issues paper

March 2018

Prepared by Policy and Strategy, Inland Revenue, and the Treasury

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CHAPTER 1

Introduction

Background

- 1.1 The Government has committed to a number of policy measures aimed at making the tax system fairer and improving housing affordability for owner-occupiers by reducing demand from speculators and investors.
- 1.2 One of these measures is to introduce loss ring-fencing on residential properties held by speculators and investors. This means that speculators and investors will no longer be able to offset tax losses from their residential properties against their other income (for example, salary or wages, or business income), to reduce their income tax liability.

Current settings

- 1.3 Under current New Zealand tax settings, tax is applied on a person's net income. We do not generally ring-fence income and losses from particular activities or investments. This means that there is generally no restriction on losses from one source reducing income from other sources – though there are some exceptions to this general treatment.¹
- 1.4 Investment housing is currently taxed under the same rules that generally apply to other investments. This means that rents are income, and interest and other expenses (other than capital improvements) are deductible. Capital gains on sale of the property are not taxed unless the property is on revenue account. This could be, for example, because you are in a land-related business (for example, a land dealer or developer), bought the land for resale, or sell the property within the bright-line period of either two or five years (depending on when you first had an interest in the land).² Most rental property investors hold their property on capital account and are not subject to tax on the capital gain.
- 1.5 While rental housing is not formally tax favoured, there is an argument that it may be under-taxed given that tax-free capital gains are often realised when rental properties are sold. The fact that rental property investors often make persistent tax losses indicates that expected capital gains are an important motivation for many investors purchasing rental property. While interest and other expenses are fully deductible, in the absence of a comprehensive

¹ For example, there are loss ring-fencing rules in relation to the bright-line test, which taxes sales of residential land bought and sold within either two or five years (depending on when you first had an interest in the land), and also in relation to the mixed-use asset rules, which may apply to assets that are used both privately and to earn income.

² The bright-line period is two years if you first acquired an estate or interest in the land on or after 1 October 2015, but is five years if you first acquired an estate or interest in the land on or after the date the Taxation (Annual Rates for 2017–18, Employment and Investment Income, and Remedial Matters) Act 2017 is enacted.

capital gains tax, not all of the economic income generated from rental housing is subject to tax. There is therefore an argument that, to the extent deductible expenses in the long-term exceed income from rents, those expenses in fact relate to the capital gain, so should not be deductible unless the capital gain is taxed.

Aim of the proposed changes

- 1.6 The introduction of loss ring-fencing rules is aimed at levelling the playing field between property speculators/investors and home buyers. Currently investors (particularly highly-g geared investors) have part of the cost of servicing their mortgages subsidised by the reduced tax on their other income sources, helping them to outbid owner-occupiers for properties. Rules that ring-fence residential property losses, so they cannot be used to reduce tax on other income, is intended to help reduce this advantage and perceived unfairness.
- 1.7 Officials are interested in feedback on the suggested changes outlined in this paper.

How to make a submission

- 1.8 Officials invite submissions on the suggested changes and points raised in this issues paper. Send your submission to policy.webmaster@ird.govt.nz with “Ring-fencing rental losses” in the subject line.
- 1.9 Alternatively, submissions can be sent to:

Ring-fencing rental losses
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140
- 1.10 The closing date for submissions is **11 May 2018**.
- 1.11 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it would be acceptable for Inland Revenue and Treasury officials to contact those making the submission to discuss the points raised, if required.
- 1.12 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their release. The withholding of particular submissions, or parts thereof, on the grounds of privacy, or commercial sensitivity, or for any other reason, will be determined in accordance with that Act. Those making a submission who consider that there is any part of it that should properly be withheld under the Act should clearly indicate this.

CHAPTER 2

Summary of the suggested changes

- 2.1 The proposed loss ring-fencing rules will mean that speculators and investors with residential properties will no longer be able to offset tax losses from those properties against their other income (for example, salary or wages, or business income), to reduce their tax liability. The losses can be used in future years, when the properties are making profits, or if the person is taxed on the sale of land.
- 2.2 A summary of officials' suggestions for the design of the loss ring-fencing rules is set out below. These design issues are discussed in more detail in the chapters that follow.

Property the rules will apply to

- 2.3 It is proposed that the loss ring-fencing rules will apply to “residential land”. We suggest that the rules use the definition of “residential land”³ that already exists for the bright-line test which taxes sales of residential land bought and sold within either two or five years.⁴
- 2.4 The rules would **not** apply to:
- a person's main home;
 - a property that is subject to the mixed-use assets rules (for example, a bach that is sometimes used privately and sometimes rented out); or
 - land that is on revenue account because it is held in a land-related business⁵ (that is, a business of land dealing, development of land, division of land, or building).

Portfolio basis

- 2.5 It is suggested that the loss ring-fencing rules should apply on a portfolio basis. That would mean that investors would be able to offset losses from one rental property against rental income from other properties – calculating their overall profit or loss across their portfolio.

³ In section YA 1 of the Income Tax Act 2007.

⁴ The bright-line period is two years if you first acquired an estate or interest in the land on or after 1 October 2015, but is five years if you first acquired an estate or interest in the land on or after the date the Taxation (Annual Rates for 2017–18, Employment and Investment Income, and Remedial Matters) Act 2017 is enacted.

⁵ As per section CB 7 of the Income Tax Act 2007.

Using ring-fenced losses

- 2.6 Under the suggested changes, a person's ring-fenced residential rental or other losses from one year could be offset against their:
- residential rental income from future years (from any property); and
 - taxable income on the sale of any residential land.

Interposed entities

- 2.7 Under the suggested changes, there would be special rules to ensure that trust, company, partnership, or look-through company cannot be used to get around the ring-fencing rules. It is proposed that such an entity will be regarded as "residential property land-rich" if over 50 percent of its assets are residential properties within the scope of the ring-fencing rules, and/or shares or interests in other residential property land-rich entities. Where that is the case, it is suggested that any interest a person incurs on money they borrow to acquire an interest in the entity (for example, shares, securities, a partnership interest, or an interest in the trust estate) would be treated as rental property loan interest. The rules could then ensure that the interest deduction is only allocated to the income year in question to the extent it did not exceed the distributions from the entity (deemed rental property income), any other residential rental income, and residential land sale income. Any excess of interest over distributions, rental income, and land sale income would be carried forward and treated as "rental property loan interest" for the next income year.

Timing of the introduction of the rules

- 2.8 It is proposed that the loss ring-fencing rules will apply from the start of the 2019–20 income year. The rules could either apply in full from the outset, or they could be phased in over two or three years. We are interested in feedback on which of those approaches should be taken.

CHAPTER 3

Property the rules will apply to

- 3.1 Under the proposed changes, the loss ring-fencing rules would apply to “residential land”. The rules would use the definition of “residential land” that already exists for the bright-line test.
- 3.2 The rules would **not** apply to:
- a person’s main home;
 - a property that is subject to the mixed-use assets rules (for example, a bach that is sometimes used privately and sometimes rented out); or
 - land that is on revenue account because it is held in a land-related business⁶ (that is, a business of land dealing, development of land, division of land, or building).

Definition of “residential land”

- 3.3 There is already a definition of “residential land” in the Income Tax Act, which is used for the bright-line test which taxes sales of residential land bought and sold within two years. It is proposed that the loss ring-fencing rules apply to land within that definition – with the exceptions discussed below. Using the definition already in the legislation would avoid the additional complexity of having different definitions for different rules.
- 3.4 “Residential land” means:
- land that has a dwelling on it;
 - land for which there is an arrangement to build a dwelling on it; and
 - bare land that may have a dwelling built on it under the relevant operative district plan rules.

However, “residential land” does **not** include:

- farmland; and
 - land used predominantly as business premises.
- 3.5 “Residential land” is not limited to land in New Zealand – it would extend to overseas land. This means that losses from overseas residential rental investments could not be offset against other income in New Zealand.
- 3.6 Apart from the exceptions below, the rules would apply to all residential land, whether or not it is currently rented out, including bare land. This is

⁶ As per section CB 7 of the Income Tax Act 2007.

because the proposed rules are aimed at levelling the playing field between residential property speculators/investors and people looking to buy their own home or land to build a home on.

Main home

- 3.7 The proposed loss ring-fencing rules will not apply to a person's main home. This is to ensure that a person who has a boarder in their main home, or who rents out a spare room occasionally, would not have to apply these rules, which are primarily targeted at residential investment properties. The meaning of "main home" would be the same as for the bright-line test, which has a main home exclusion.
- 3.8 A person can only have one main home at a time. If someone has more than one residence, their "main home" would be the one they have the greatest connection with. That would be determined by looking at factors such as:
- the amount of time the person occupies the dwelling;
 - where their immediate family live;
 - where their social ties are strongest;
 - their use of the dwelling;
 - their employment, business interests and economic ties to the area where the dwelling is located; and
 - where their personal property is kept.

Trusts

- 3.9 A significant number of family homes in New Zealand are owned by family trusts. The definition of "main home" would therefore ensure that a home owned by a trust can be regarded as a main home.
- 3.10 Like with the bright-line rules, we suggest that a dwelling owned by a trust only be considered a main home (so not subject to the loss ring-fencing rules) if it is the main home for a beneficiary of the trust, provided that a principal settlor of the trust does not have a different main home.
- 3.11 This restriction would ensure that trust ownership cannot be used to claim multiple properties as main homes, and so not subject to the loss ring-fencing rules.

Mixed-use assets

- 3.12 The existing definition of "residential land" in the Income Tax Act would also include holiday houses that are sometimes used privately and sometimes rented out. However, many such properties would be subject to the mixed-use asset rules, which already provide for the quarantining (or ring-fencing) of losses where there is low income-earning use of the asset.

- 3.13 We suggest that property subject to the mixed-use asset rules should be scoped out of the rental loss ring-fencing rules, because the mixed-use asset quarantine rules will cover most if not all mixed-use asset losses. We are interested in feedback on whether property subject to the mixed-use asset rules should be outside the scope of the loss ring-fencing rules.

Revenue account land in dealing, development, subdivision and building businesses

- 3.14 Land that is held in certain land-related business is on revenue account, so the profits on sale are taxed. This applies to land held in dealing, development, subdivision, and building businesses.
- 3.15 At balance date, taxpayers in these businesses are likely to have a number of properties on hand, though they may not be currently rented out.
- 3.16 As discussed in chapter 5, it is proposed that residential rental or other losses could be used against taxable land sales to reduce the taxable gain to nil, with any further unused losses remaining ring-fenced to future rental income or taxable income on land sales. While taxpayers in the business of land dealing, development of land, division of land, or building may have losses in respect of properties on hand at balance date, those losses being able to be used against income from other sales or rental activity in the year would mean that their businesses would be unlikely to be disadvantaged by the ring-fencing rules. In most cases the income from their sale or rental activity would be expected to exceed their losses.
- 3.17 However, in any overall loss-making year, we do not consider it necessary to ring-fence losses for land held in these businesses. There is not the same concern about any of the deductible expenses in relation to land in these businesses relating to untaxed gains, as all of the businesses' land is on revenue account. Therefore, we propose that the ring-fencing rules not apply to land that is on revenue account because it is held in a land-related business.⁷ This would enable taxpayers in these businesses to use losses arising in any year against other income – for example within their corporate group (as they are likely to be companies).

Property owned by companies and trusts

- 3.18 There is an argument that the loss ring-fencing rules should apply only to individuals (that is, natural persons),⁸ and not to companies or trusts. This argument could be made because company losses are effectively ring-fenced inside the company, as are losses in a trust.

⁷ As per section CB 7 of the Income Tax Act 2007.

⁸ This would include a natural person with an effective interest in a look-through company with residential property losses.

- 3.19 However, such an approach would leave open the possibility of individual speculators or investors operating through a company or trading trust, holding their residential properties in that vehicle, and offsetting the losses against their labour income. It would also mean that a family trust holding residential rental property and also some other investments could offset rental property losses against income from the other investments. For example, it would not be fair for a professional operating through a company or trust to not be subject to the ring-fencing rules where another person operating as a sole trader would be.
- 3.20 It is acknowledged that there may be some compliance costs for some corporates that own some residential property incidentally to their business. However, it is considered that limiting the ring-fencing rules to individuals would significantly undermine the fairness of the rules. For this reason, we suggest that the ring-fencing rules should apply to all taxpayers, not only to individual taxpayers.

CHAPTER 4

Portfolio basis

- 4.1 It is suggested that the loss ring-fencing rules should apply on a portfolio basis. That would mean that investors would be able to offset losses from one rental property against rental income from other properties – calculating their overall profit or loss across their portfolio.
- 4.2 The alternative – a property by property basis – would mean that each property would need to be looked at separately, with losses on one not able to be offset against income from another.
- 4.3 A property by property approach would be stricter than a portfolio approach, achieving the highest level of ring-fencing. However, it would add complexity, as losses would need to be tracked separately for each property. Moreover, a property by property approach may just result in taxpayers with portfolios re-balancing their debt funding to avoid having loss-making properties (or at least minimising the extent to which any particular property is loss-making). That response to the rules applying on a property by property basis would be inefficient, and may mean that this approach may have no real advantage over a portfolio approach – adding considerable complexity and increasing compliance costs for no real gain.
- 4.4 Also, a property by property approach may be seen as unfair in that if a taxpayer has two properties and breaks even on the portfolio overall, the taxpayer's tax position would depend on whether they break even on both properties or make a gain on one and a loss on the other.
- 4.5 We therefore suggest that the ring-fencing rules apply on a portfolio basis, so a person with multiple properties would calculate their overall profit or loss across their whole residential portfolio.

CHAPTER 5

Using ring-fenced losses

- 5.1 Under the suggested changes, ring-fenced residential rental or other losses from one year would could be offset against:
- residential rental income from future years (from any property); and
 - taxable income on the sale of any residential land.
- 5.2 Most residential rental investors are not subject to tax on the sale of their investment properties under current tax rules. However, in some circumstances, the sale of a residential rental property may be taxed under one of the land sale rules in the Income Tax Act – or the taxpayer may have taxable income on the sale of other residential property (not rented out). This could be the case, for example, because the taxpayer is in a land-related business (for example, a land dealer or developer), bought the land for resale, or sells the property within the bright-line period of either two or five years (depending on when they first had an interest in the land).⁹
- 5.3 Under the suggested changes, where a taxpayer sells a property that is subject to the ring-fencing rules (that is, a residential property) and the sale is taxed, any ring-fenced losses the taxpayer has could be used to reduce the taxable gain on sale to nil. Any remaining unused losses would stay ring-fenced, and could be used against any future residential rental income or taxable income on other residential land sales.
- 5.4 There is an argument that in the case of a property with ring-fenced losses that is taxed under one of the land sale rules on disposal, the losses should be able to fully utilised (that is, un-fenced) at that point, and be used to offset any other income of the taxpayer. This would reflect that all of the economic income from the investment has been taxed (the rental stream and the capital gain), and that the investor should not be penalised for making an overall loss on the investment.
- 5.5 However, if the rules are to apply on a portfolio basis, as suggested, allowing accumulated losses to give rise to a tax loss on a disposal subject to one of the land sale rules would create risks. For example, it would enable a portfolio investor to sell a property that has made a small capital gain within the bright-line period, offset that gain with ring-fenced losses from across their portfolio, and apply any remaining losses from the portfolio against other income. While there are ring-fencing rules in relation to the bright-line test, they only apply to deductions for the cost of the land, not other costs.

⁹ The bright-line period is two years if you first acquired an estate or interest in the land on or after 1 October 2015, but is five years if you first acquired an estate or interest in the land on or after the date the Taxation (Annual Rates for 2017–18, Employment and Investment Income, and Remedial Matters) Act 2017 is enacted.

- 5.6 Enabling taxpayers to sell their lowest capital gain makers within the bright-line period and access what might be substantial portfolio-wide accumulated ring-fenced losses would significantly undermine the credibility of the rules.
- 5.7 For this reason, we propose that where a disposal is caught by one of the land sale rules, ring-fenced losses should be allowed to be used only to the extent they reduce the taxable gain to nil, with any further unused losses remaining ring-fenced.

CHAPTER 6

Structuring around the rules

- 6.1 There are two main structuring opportunities that we have considered creating specific rules to deal with. These concern interest allocation and the interposing of entities.

Interest allocation

- 6.2 We have considered whether specific interest allocation rules are required, as without them investors may be able to structure around the loss ring-fencing rules. For example, this could be done by reorganising funding so that business assets other than rental properties are debt-funded, and rental properties are equity-funded to the greatest extent possible.
- 6.3 However, interest allocation rules would add substantial complexity and compliance costs. Because money is fungible, it is very difficult to attempt to match borrowings to particular investments (tracing). Stacking rules (for example, allocating debt firstly to ring-fenced investments) may be seen as unfair. And pro rata interest allocation between assets that are subject to the ring-fencing rules and those that are not would require regular valuation of assets.
- 6.4 If interest on any loan that was secured by a residential property was included in the rules, this would create issues for many people who use their rental properties to secure loans for their businesses. This would impact on small and medium business' access to capital. In addition, many arrangements could be even more difficult to apply interest allocation rules to, as revolving credit facilities are often used to fund both a rental property and a business.
- 6.5 We do not propose specific interest allocation rules because of the considerable complexity and compliance costs they would add, which would be particularly onerous on smaller taxpayers.

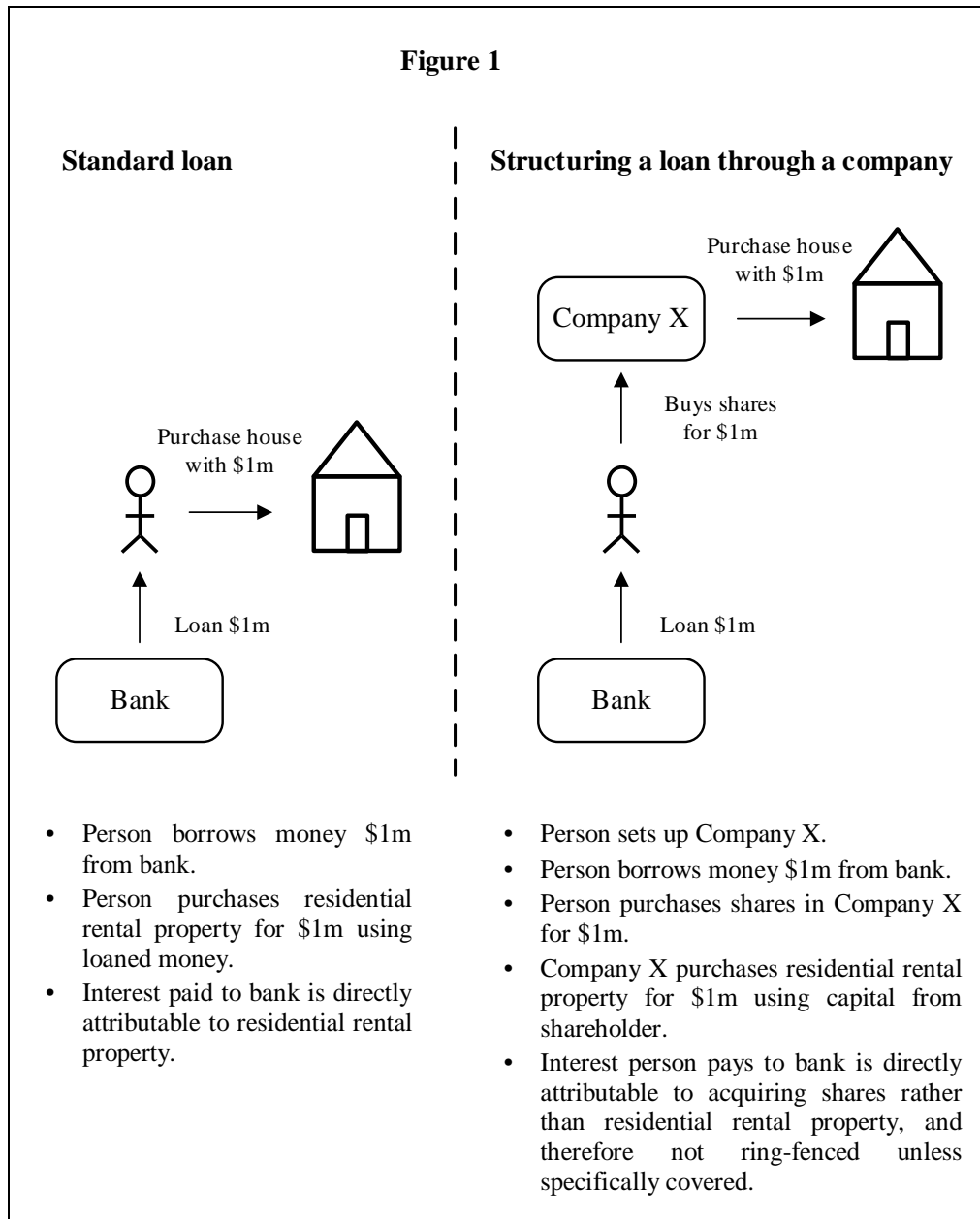
Interposed entities

- 6.6 Under the suggested changes, there would be special rules to ensure that a trust, company, partnership, or look-through company cannot be used to get around the ring-fencing rules. These ownership structures are referred to here as entities for simplicity.
- 6.7 Otherwise a simple way to get around the ring-fencing rules would be for a taxpayer to interpose an entity to hold a residential rental property, and borrow money to invest in or acquire an interest in the entity. For example, a taxpayer could borrow money to buy shares in a company, which uses those funds to buy a residential investment property. Because the money is borrowed to buy shares, the individual taxpayer would be able to claim

deductions for the interest on the borrowings, and offset those amounts against other income sources.

6.8 However, if the taxpayer had used the borrowed money to purchase the property directly themselves, the interest expense would be attributable to the residential rental investment, not shares, so would be taken into account in determining whether the person's residential rental activity was profit or loss-making. And if the rental activity was loss-making, losses would be ring-fenced under the proposal rules.

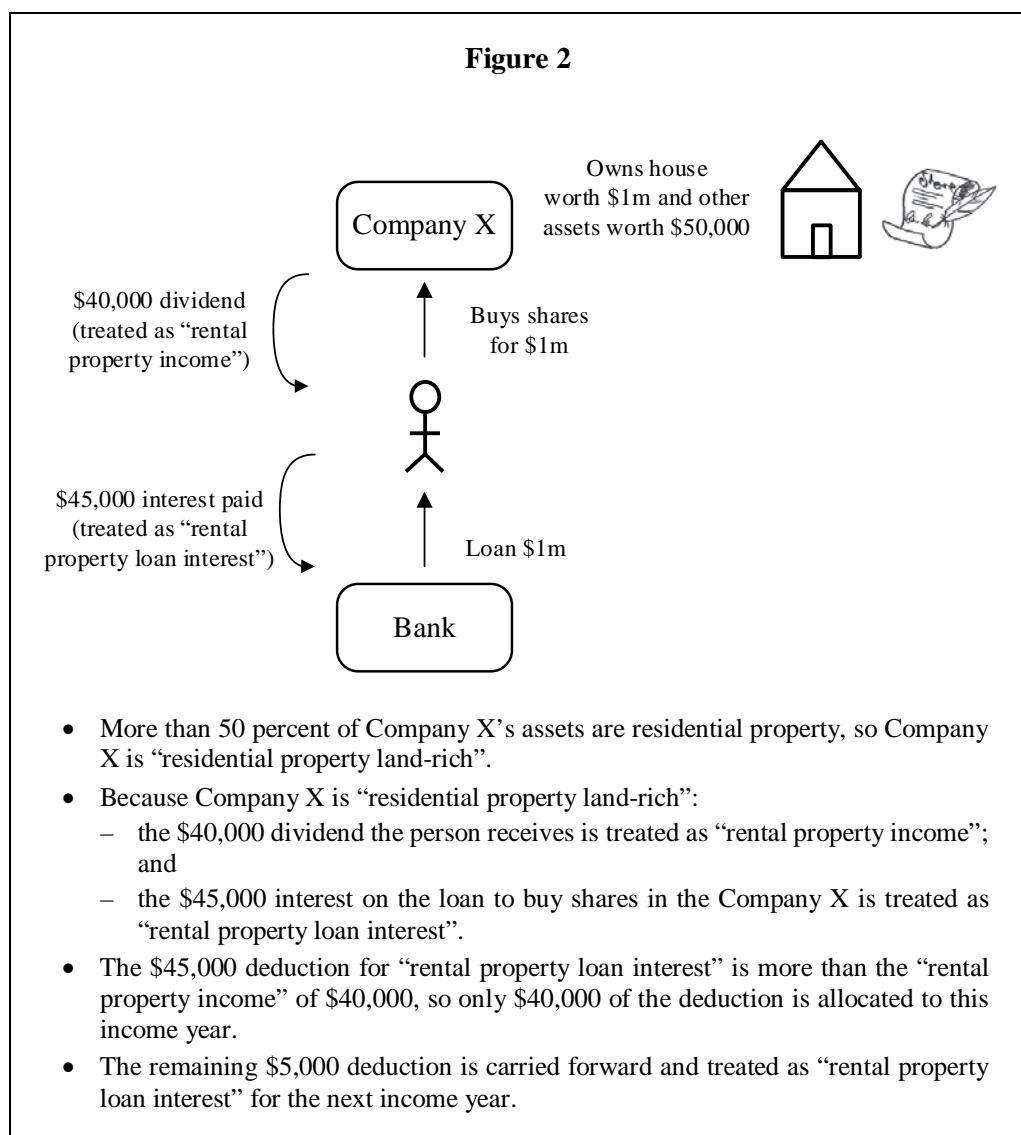
6.9 This simple mechanism is illustrated in figure 1.



6.10 A specific rule to deal with the interposing of entities would ensure that this simple mechanism cannot be used to get around the loss ring-fencing rules, undermining their credibility.

6.11 A suggested approach to dealing with interposed entities is to specifically define when such entities would be “residential property land-rich”. It is proposed that this would be the case where over 50 percent of the entity’s assets are residential properties within the scope of the ring-fencing rules, and/or shares or interests in other residential property land-rich entities. The rules could then treat dividends, interest, or distributions from the entity as being “rental property income”, and treat interest on borrowings to acquire an interest in the entity (for example, shares, securities, a partnership interest, or an interest in the trust estate), as “rental property loan interest”. The rules could then ensure that the interest deduction is only allocated to the income year in question to the extent it did not exceed the distributions from the entity (deemed rental property income), any other residential rental income, and residential land sale income (as discussed in chapter 5). Any excess of interest over distributions, rental income, and land sale income would be carried forward and treated as “rental property loan interest” for the next income year. This would mean that losses from rental properties would not reduce the tax on other sources of income.

6.12 This suggested approach is illustrated in figure 2.



6.13 We are interested in feedback on this suggested approach to preventing the simple interposition of an entity to get around the ring-fencing rules.

CHAPTER 7

Timing of introduction of the rules

- 7.1 It is proposed that the loss ring-fencing rules will apply from the start of the 2019–20 income year.
- 7.2 The rules could either apply in full from the outset, or alternatively they could be phased in over two or three years. If the rules are phased in, this would be done by reducing the proportion of losses that could be used to offset other income over a two or three year period, until no losses could be used to offset other income sources. For example, if phased in over two years, 50 percent of residential investment losses could be used to offset other income in 2019–20, and no offsetting would be allowed in 2020–21.
- 7.3 Tax law changes are not usually phased in. But this possible approach has been suggested to allow affected investors more time to adjust to the new rules, or to rearrange their affairs before the rules apply in full. However, we note that phased introduction of the rules would result in some additional complexity.
- 7.4 We are interested in feedback on whether the loss ring-fencing rules should apply in full from the 2019–20 income year – the simpler approach – or be phased in over two or three years.