Supplementary Order Paper to the Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Bill

Commentary on the proposed amendments to:

- *interest limitation*
- *the bright-line test*
- *business continuity test, and*
- *FBT*

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Supplementary Order Paper to the Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Bill: Commentary

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Introduction

OVERVIEW

Supplementary Order Paper No.64 contains further measures to be added to the Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Bill (the Bill).

The proposed changes would:

- limit the deductibility of interest on residential investment property
- introduce a five-year bright-line period for owners of new build properties
- amend the current bright-line rules to accommodate the proposed changes
- provide employers with another option for paying fringe benefit tax, and
- clarify the application of the business continuity test for carrying forward losses.

The proposed changes would amend the Income Tax Act 2007 and the Tax Administration Act 1994.

This Commentary provides information on the proposed changes. The structure of the Commentary follows the sequential process taxpayers would adopt to apply the proposed interest limitation changes.

Interest limitation

The interest limitation reform proposed is 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 current tax system allows landlords to deduct all interest expenditure for residential rental property, even if no tax is paid on any capital gain on sale. The proposals would limit the deductibility of interest expenses incurred by residential property investors from 1 October 2021. The extent of the limitation would depend on whether the property was acquired on or after 27 March 2021.

Summary of key proposals

- **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 would be subject to the proposed interest limitation rules. This property is referred to as disallowed residential property (DRP).
- **Excepted residential land:** Certain types of property not suitable for long-term residential accommodation, and which cannot easily be substituted for such, would be excluded from DRP and not subject to the proposed interest limitation rules.
- **Application to certain companies:** The provision allowing for an automatic deduction of interest for most companies would be overridden for certain close companies and companies whose assets are primarily DRP. These companies would be required to trace the use of their borrowed funds and would be denied deductions for interest incurred on borrowings used to derive income from DRP.

- **Interposed entities:** Interposed entity rules would ensure taxpayers could not claim interest deductions for borrowings used to acquire DRP indirectly through an interposed entity.
- **Exemptions:** Land businesses, property development and new builds would be exempt from the interest limitation rules.
- **Interest subject to limitation:** From 1 October 2021, deductions would be denied for interest incurred in deriving income from DRP acquired on or after 27 March 2021 (subject to certain exceptions). For DRP acquired before this date, deductions for such interest would be progressively denied over the period between 1 October 2021 and 31 March 2025. DRP owners would be 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 same tracing approach as currently applies (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) would apply for loans used to fund DRP. This would include 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 would not be affected by the interest limitation rules).
- **Interest deductions on taxable sale of property:** Interest deductions would be allowed on the taxable sale of the DRP.

Bright-line test changes

As another part of the Government's initiatives to improve housing affordability, the Supplementary Order Paper also proposes several changes to the bright-line rules for sales of residential land be added to the Bill.

Summary of key proposals

- **Bright-line test for new builds:** Owners of new builds would be subject to a 5-year bright-line period, rather than the current 10-year period.
- **Amendment to main home exclusion:** The portion of land attributable to the main home would not generally be taxed on disposal under either the 10-year or 5-year new build bright-line tests.
- **Rollover relief:** Limited extensions to rollover relief from the bright-line test would be available for some common ownership change scenarios where economic ownership has not changed or is materially the same as it was before.

Legislative references

All legislative references in this Commentary are to the Income Tax Act 2007 unless otherwise stated.

Interest limitation

DEFINITION OF DISALLOWED RESIDENTIAL PROPERTY

Clauses 64E (proposed section DH 5(2)), 127(4B) and (7B), 131B, and schedule 1A

Summary of proposed amendment

The proposed new interest limitation rules would apply to "disallowed residential property", and the proposed amendment would introduce a definition of that term. "Disallowed residential property" would mean 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 would exclude "excepted residential land".

Application date

The proposed amendments would come into force on 27 March 2021 with application from 1 October 2021.

Key features

Proposed new subpart DH would introduce the interest limitation rules. These rules would deny an interest deduction for interest incurred for disallowed residential property (DRP) on or after 1 October 2021.

Proposed new section DH 5 would define the key terms that give the scope of the land and property subject to the interest limitation regime. The relevant terms are "disallowed residential property" (DRP) (defined in subsection (2)) and "excepted residential land" (defined in subsection (3) and proposed new schedule 15).

The proposed 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 is proposed to apply to structures that could be used as a residence or abode. Whether they are used as such is not considered by the proposed definition.

Excepted residential land would be excluded from being DRP. Excepted residential land is described in proposed new schedule 15.

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 would apply to exclude the part that is excepted residential land. This means that the proposed interest limitation rules would only apply to the portion of the land that relates to the residence or abode.

Background

The proposed new interest limitation rules should apply to properties that are, or could be, commonly and foreseeably used to provide long-term residential accommodation. The focus should be 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 should apply to property that could be used for private owner-occupation. In practice, this would mean most houses and apartments would be subject to interest limitation unless a specific exclusion applies.

A focus on 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) and this could impact the supply of properties available for long-term occupation (either rented or owner-occupied).

Broadly speaking, DRP should cover land that has a house, apartment, or flat on it, land on which such a structure is being, or is intended to be, erected, and bare land that could be used for erecting such a structure under the relevant district plan.

However, certain types of land and property would be considered "excepted residential land" and would not be subject to interest limitation. This carve-out is necessary to ensure that other buildings on the same parcel of land as a house, apartment or flat would not be subject to interest limitation if they are not configured for residential accommodation – for example, a shop and flat on the same legal title. The proposed exclusions are included for a variety of reasons, such as the existence of regulatory frameworks or conditions of occupation that limit who can occupy or own certain properties, or significant legal or structural barriers preventing properties from being converted into standard residential properties or vice versa.[1]

Detailed analysis

Disallowed residential property

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

- it has a place configured as a residence or abode, whether or not it is used as such (paragraph (a)(i))
- the owner has an arrangement that relates to erecting a place there, configured as a residence or abode, whether or not it is, or is to be, used as such (paragraph (a)(ii)), or
- it is bare land that, under rules in the relevant operative district plan, may be used for erecting a place there configured as a residence or abode, whether or not it 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.[2]

[1] For more on this, see the "Excepted residential land – schedule 15" section of this Commentary.

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

Residential properties that are not in New Zealand would not be DRP and would therefore not be subject to interest limitation under subpart DH.

The proposed definition is based on the existing definitions of "residential land" and "dwelling" used for other purposes in the Income Tax Act 2007, but it has the benefit of being self-contained within proposed new subpart DH.

Land would not be considered DRP, and therefore would not be subject to interest limitation, to the extent to which it is "excepted residential land" (proposed new section DH 5(2)(b)).

Excepted residential land

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

Use of the phrase "to the extent" means that where some areas of a given parcel of land or property meet the criteria but others do not, a reasonable apportionment would have to be made according to general tax apportionment principles. This would usually only be 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 straightforward to distinguish between interest that relates to excepted residential land and interest that relates to the DRP.

Example 1: Dual purpose land and interest limitation

Tāmati owns a two-storey building with mixed residential and commercial use. The ground floor is a clothing store, and the upper storey 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 upper-storey apartment would therefore constitute DRP, but the clothing store on the ground floor would not.

Following standard principles for apportionment, Tāmati calculates that the clothing store on the ground floor accounts for 55%, and the upper storey for 45%, of the interest paid on his loan. Therefore, Tāmati would be subject to interest limitation under subpart DH for 45% of his interest expense, as this would be interest that relates to DRP. For the period from 1 October 2021 to 31 March 2025, a portion of the 45% would be denied in accordance with the table in proposed section DH 8(2).

SOCIAL, EMERGENCY, TRANSITIONAL, AND COUNCIL HOUSING

Clause 64E (proposed sections DH 4(4), (5) and (6))

Summary of proposed amendment

The proposed amendment would exclude land used by a social housing provider or a council-controlled organisation to provide social, emergency, transitional and council housing from the proposed new interest limitation rules.

Application date

The proposed amendment would come into force on 27 March 2021 with application from 1 October 2021.

Key features

Proposed new section DH 4(4) provides that the proposed new interest limitation rules would not apply to interest incurred by a person to the extent the interest is incurred for a dwelling owned or rented by a social housing provider and used by a social housing provider to provide social, emergency or transitional housing. A social housing provider would be defined as a registered community housing provider (CHP), Kāinga Ora–Homes and Communities (Kāinga Ora), or another government department.

Proposed new section DH 4(5) provides that the proposed interest limitation rules would not apply to interest incurred by a council-controlled organisation (CCO) to the extent to which the interest is incurred for a CCO-owned dwelling used to provide council housing.

Proposed new section DH 4(6) provides that the proposed interest limitation rules would not apply to Kāinga Ora and its wholly-owned subsidiaries.

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, housing offered at below market rent by registered community housing providers, 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.

The proposed interest limitation rules would not generally affect emergency, transitional or public housing properties owned by Kāinga Ora or CHPs. This is because proposed section DH 4(6) provides that the interest limitation rules would not apply to Kāinga Ora (which is subject to income tax), and CHPs will often be charities and therefore exempt from income tax or subject to another income tax exemption (for example, section CW 42B). However, without a specific carve-out, properties used for emergency, transitional or public housing that are owned by a non-exempt CHP, or leased by private landlords to a CHP, Kāinga Ora, or the Crown, would be subject to the proposed rules. In addition, some council housing is provided by CCOs, which are not exempt from income tax, and would be subject to the rules.

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

Detailed analysis

Social, emergency, and transitional housing

Proposed new section DH 4(4) specifies that proposed subpart DH would not apply to interest incurred by a person to the extent to which the interest relates to a dwelling that is owned or rented by a social housing provider and used by a social housing provider for the provision of social housing or temporary accommodation for people in need.

A "social housing provider" would be a person who is one or more of the following:

- a registered community housing provider under the Public and Community Housing Management Act 1992 (section DH 4(4)(b)(i))
- Kāinga Ora or a wholly owned subsidiary of Kāinga Ora (section DH 4(4)(b)(ii)), or
- a department listed in schedule 2, part 1 of the Public Service Act 2020 (section DH 4(4)(b)(iii)).

To qualify for the exemption, the dwelling would have to be used by a social housing provider for the sole purpose of providing:

- "social housing" as defined in section 2 of the Public and Community Housing Management Act 1992 (section DH 4(4)(a)(i)), or
- temporary accommodation for people in need while they seek, or are assisted in finding, more permanent accommodation (section DH 4(4)(a)(ii)).

The proposed exemption would only apply to the extent to which a given dwelling meets at least one of the conditions in each of both proposed sections DH 4(4)(a) and (b). If a property meets a condition in either section DH 4(4)(a) or (b) but not the other, it would be subject to interest limitation. For example, if a house owned by a community housing provider was rented out at normal market rent, and not as social housing, only section DH 4(4)(b) would be satisfied and the exemption from the interest limitation rules would not apply.

Proposed section DH 4(4)(b) also provides that the dwelling would need to be either owned or rented by a social housing provider to qualify for the exemption.

The social housing provider that owns or rents the dwelling would not need to be the same social housing provider that provides the social, emergency or transitional housing. For example, one entity may be responsible for managing the property portfolio but 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 social housing provider would also be able to qualify for the exemption for the duration of the lease, even if they are not a social housing provider themselves and have no interaction with the individual tenant. However, the exemption would 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 in proposed section DH 4(4) would apply on a dwelling-by-dwelling basis.

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

In addition, the whole dwelling would need to be used for social, emergency or transitional housing to qualify for the exemption. If only one room in a dwelling is rented by a social housing provider and the other rooms are rented to third parties, the exemption in section DH 4(4) would not apply.

The proposed exemption would cover periods of vacancy between social housing tenants if the property continues to be under lease to the social housing provider 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 are "to be let" as Kāinga Ora housing.

In contrast, for example, if a DRP is occasionally rented by a social housing provider 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 2: 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 would be exempt from the interest limitation rules while it is under lease to the CCH Trust. This would include the period it is vacant from 8 June 2022 to 31 July 2022.

Example 3: Property occasionally rented by social housing provider

Kris owns a house in the Bay of Plenty that is occasionally rented by a social 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 social 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 would qualify 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, the properties may be owned by taxable CCOs.

Proposed new section DH 4(5) specifies that subpart DH would not apply to interest incurred by a CCO to the extent the interest is incurred for a dwelling owned by the CCO and used by the CCO or a local authority for the sole purpose of providing housing to people assessed by a local authority as being eligible for housing at less than market rent.

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

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

APPLICATION TO COMPANIES

Clauses 57B, 64E (proposed sections DH 3, DH 5(4), (8), (9), (10), (11) and DH 12) and 127(7D), (16B) and (16C)

Summary of proposed amendment

The proposed amendments would apply the interest limitation rules to all companies whose core business involves disallowed residential property (DRP) (other than DRP subject to the land business or development exemptions) and to most close companies that hold DRP. Companies that are not close companies and whose core business does not involve DRP would not have to apply the rules.

Application date

The proposed amendments would come into force on 27 March 2021 with application to companies incurring interest on or after 1 October 2021.

Key features

Under the proposed amendments, "residential land companies" and "residential land wholly-owned group members" would have to apply the interest limitation rules. These are companies whose core business involves DRP (other than DRP subject to the land business or development exemptions). In general terms, a "residential land company" would be a company where the value of its DRP makes up more than 50 percent of the value of its total assets. A "residential land wholly-owned group member" would be a member of a wholly-owned group where the value of the group's DRP makes up more than 50 percent of the group's total assets.

In addition, most close companies that own DRP would have to apply the rules, even if they are not a residential land company or a residential land wholly-owned group member. An exception would apply for a close company that is an "exempt Māori company". An "exempt Māori company" would be a company that meets certain requirements and is not a residential land company or a residential land wholly-owned group member.

Background

Under current law (section DB 7), companies are generally allowed deductions for interest incurred without having to trace their borrowings or show a nexus with assessable income. There are two main reasons for this:

- First, for companies and corporate groups with many different sources of funds, a tracing approach can be extremely difficult to apply.
- Second, borrowings in companies will almost always have a nexus with income as taxpayers usually will not put private assets, such as a main home, into a company. This is because companies are legally separate from their shareholders and almost all distributions of value to shareholders are treated for tax purposes as taxable dividends to the shareholder. If a taxpayer put their main home into a company, the value of accommodation provided by the company to the shareholder would become a taxable

dividend (whereas the value of accommodation would not be taxed if the shareholder held their main home directly).[3]

Since almost all borrowings in companies have a nexus with income, most companies would be able to deduct all their interest expenditure even without section DB 7. However, they may incur high compliance costs to do so. Section DB 7 was therefore intended to remove compliance costs in situations where taxpayers would usually be entitled to deductions anyway.

However, for those companies that have to apply the proposed new interest limitation rules in subpart DH, section DB 7 will not apply.

Detailed analysis

The proposed new interest limitation rules in subpart DH would only apply to those companies included in proposed new section DH 3. All other companies would not be subject to the new rules. Even without proposed new section DH 3, those other companies would usually be able to deduct all their interest expenditure by ensuring that their borrowings are traced to non-DRP assets. Thus, proposed new section DH 3 is intended to reduce these companies' compliance costs rather than change their tax position.

Proposed new section DH 3 provides that the new rules would apply to a company that is:

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

Application to residential land companies and residential land wholly-owned group members

Residential land companies and residential land wholly-owned group members are both included in section DH 3 and would have to apply the interest limitation rules. This is because these companies may not be able to ensure that all borrowings are traced to non-DRP assets.

Residential land company

A company would be a "residential land company" for an income year if the value of its disallowed property and indirect disallowed property is equal to or greater than 50 percent of the value of its total assets at any time during that income year. The formula is set out in proposed new section DH 5(8):

$$(\textit{disallowed property} + \textit{indirect disallowed property}) \div \textit{total assets}$$

Although a company would be a residential land company if it reached the 50 percent threshold at any time during an income year, in practice it is not expected that companies would have to calculate their percentage daily. Companies whose core business does not involve DRP (other than DRP subject to the land business and development exemptions) would typically be well under the 50 percent threshold at all times and may choose to

[3] For more on this, see *Interest deductions for companies* (Discussion document, September 1999) at chapters 7 and 8 [taxpolicy.ird.govt.nz]

perform the calculation only once to confirm that. If a company found it was close to the 50 percent threshold, it could either monitor its percentage carefully or decide to apply subpart DH and trace all its borrowings anyway.

To apply the formula in proposed new section DH 5(8), the company would need to work out the value of its "disallowed property" and "indirect disallowed property" (as defined in proposed new section DH 5(9)). The proposed definition of "disallowed property" includes a company's DRP but excludes property subject to the land business and development exemptions in proposed new sections DH 4(2) and (3). This is to reduce compliance costs for developers and other businesses relating to land. Such companies can hold significant amounts of property under development, and if such property were not excluded from "disallowed property", the companies could have to trace all their borrowings.

In contrast, new builds would be included in the proposed definition of "disallowed property". This is because a company whose core business is residential rental may hold a mixture of new builds and old builds. Such a company would not automatically be allowed all its interest deductions if it held slightly more new builds than old builds; it would still have to trace its borrowings to work out which interest deductions were allowed. Moreover, if new builds were excluded from "disallowed property", this could cause problems for companies in future years. For example, if a company initially held mostly new builds, it could later find itself holding mostly old builds (particularly because the new build exemption expires after 20 years) and having to apply subpart DH and trace its borrowings at that point. Unless the company had traced from the outset, it may not be able to do so.

Indirect interests in disallowed property would also have to be taken into account in determining whether a company is a residential land company. However, companies would not be required to "look through" chains of companies to work out the precise amount of disallowed property held indirectly. Instead, companies would only need to consider the value of any shares in other companies that were residential land companies. Although this would be less precise, it is expected to be easier to apply and to reduce compliance costs for taxpayers.

Example 4: 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% of the shares in B Ltd with a value of $300,000.

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

(disallowed property + indirect disallowed property) ÷ total assets

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

B Ltd's total assets consist of the following:

- Disallowed residential property 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 disallowed 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 disallowed property in the above formula.

The value of A Ltd's disallowed property and indirect disallowed 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 is part of a wholly-owned group, the formula would be applied on a group basis to work out whether the company is a "residential land wholly-owned group member". A company that is a "residential land company" but is also a member of a wholly-owned group would not need to apply subpart DH if the group is not a residential land wholly-owned group.

A residential land wholly-owned group for an income year is a wholly-owned group of companies where, on a consolidated basis, the value of the group's disallowed property and indirect disallowed property is equal to or greater than 50 percent of the value of the group's total assets at any time during that income year (proposed new section DH 5(10)).

Property subject to the land business and development exemptions, new builds, and indirect disallowed property would be treated in the same way as under the formula for residential land companies. Indirect disallowed property would be limited to the value of shares in non-group companies that are residential land companies to avoid double counting disallowed property held in the group. By applying the formula on a consolidated basis, intra-group shares and loans would also be disregarded when calculating total assets to avoid double counting property held in the group.

Example 5: 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			
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**

As 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 proposed new section DH 5(10) is applied to the Land Group:

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

The value of Land Group's disallowed property and indirect disallowed property as a percentage of its total assets would therefore be 45% ($4.5m/$10m). Land Group would therefore not be a residential land wholly-owned group. Holding Co, A Co and B Co would therefore not be residential land wholly-owned group members and would not have to apply subpart DH. This is despite the fact that, if the formula for an individual residential land company in proposed new section DH 5(8) was applied to A Co, A Co would be a residential land company.

Valuations of assets

When applying the formulas in proposed new sections DH 5(8) and (10), taxpayers would use the valuation rules set out in proposed new section DH 12. These rules are based on the existing valuation rules for residential rental loss ring-fencing in section EL 19. However, instead of requiring market value for all property other than land, section DH 12 requires the use of tax book values or accounting values (if their accounts are prepared according to relevant accounting or legislative standards).[4] This is intended to save compliance costs for taxpayers.

Application to close companies

Most close companies that own DRP would have to apply subpart DH, even if they are not residential land companies or residential land wholly-owned group members. Close companies are controlled by a small number of individuals. As such, if close companies with DRP comprising less than 50 percent of their total assets were excluded, taxpayers would have an incentive to set up a close company to hold DRP and then add other assets to the company, such as cash, bonds, and shares, to remain below the 50 percent threshold. This concern is significantly reduced for non-close companies, where control of the company is more dispersed.

An "exempt Māori company" would not have to apply the rules even if it is a close company. An "exempt Māori company" is defined in proposed new section DH 5(4) as a company that is not a residential land company or a residential land wholly-owned group member and is one of the following:

- 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.

[4] For example, financial statements prepared in accordance with applicable minimum requirements prescribed by an Order in Council made under section 21C of the Tax Administration Act 1994.

These exempt Māori companies would often legally be close companies because they are held by a single trust. However, where the company or its parent is a Māori authority (or eligible to be one), it will typically be for the benefit of, and accountable to, a very large number of members, sometimes thousands. So, in terms of control and governance, the company is not like a typical close company. Moreover, there are restrictions on the types of companies and trust that are eligible to become Māori authorities, and this means taxpayers would not be able to set up Māori authority companies simply to avoid the interest limitation rules.

LAND BUSINESS EXEMPTION

Clause 64E (proposed section DH 4(2))

Summary of proposed amendment

The proposed amendment would provide an exemption from the interest limitation rules for interest incurred by a person in relation to land they hold as part of a business described in section CB 7.

Application date

The proposed amendment would come into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Key features

Proposed new section DH 4(2) provides that interest incurred for land held as part of a business described in section CB 7 would be exempt from the proposed new interest limitation rules. Section CB 7 applies to land acquired for a land dealing, developing, subdividing or building business. This exemption is referred to as the "land business exemption".

The exemption would apply to interest incurred for land held by property developers, subdividers, dealers and builders for a land-related business described in section CB 7.

If the exemption applied, interest that was deductible before the proposed new interest limitation rules (such as interest related to the land and development activities) would remain deductible.

If all the taxpayer's land is held on revenue account under section CB 7, all their interest incurred in carrying on the land business would qualify for the exemption. If they owned some land not held on revenue account under section CB 7, the interest for that land might be subject to interest limitation, unless another exemption applied (such as the development exemption or the new build exemption).

The land business exemption would apply from the date the land was acquired for the land-related business. The exemption would cease when the taxpayer was no longer engaged in a business described in section CB 7.

Background

The aim of the land business exemption is to ensure new housing supply is not negatively impacted by the proposed new interest limitation rules. An exemption from the interest limitation for taxpayers who hold land on revenue account under section CB 7 is provided because land developers and builders play a significant role in the provision of new housing stock. The exemption is proposed to apply to interest for all land to which section CB 7 applies, even if there is no active work on the land at the time. This is because of the nature of these businesses in contributing to new housing supply.

Detailed analysis

Exemption applies to land businesses

The land business exemption is proposed to apply to interest incurred by a person to the extent it is incurred for land the person holds as part of a business described in section CB 7.

Section CB 7 applies to land acquired by taxpayers for certain land-related businesses. These businesses are:

- dealing in land
- developing or subdividing land, and
- erecting buildings.

Practically, this means people who are professional land dealers, land developers or engaged in land subdivision would 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 would also qualify for the land business exemption, provided they meet the requirements of section CB 7.

Example 6
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 would be deductible.

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 would not apply. This is because section CB 7 would not apply to the land in this case. Instead, the person would need to meet the requirements of the proposed development exemption to avoid the application of the interest limitation rules.[5]

Remediation

Section CB 7 may also encompass professional developers and dealers who primarily remediate and renovate houses if their activities qualify as undertaking a business of land dealing or erecting buildings. If section CB 7 did apply to the land, all interest incurred for remediation of existing dwellings on the land would be exempt from the proposed new interest limitation rules under the land business exemption.

[5] For more on the development exemption, see the "Exemption for property development" section of this Commentary.

Example 7: 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 would qualify for the land business exemption. All interest incurred for loans to acquire the villas, hold them, and renovate them would be deductible and not subject to the proposed new interest limitation rules.

Land dealers

The land business exemption would apply if section CB 7 applies to the land, regardless of what work (if any) is done to the land. This includes land dealers whose activity is often ancillary to the development process.

Interest allowed by the exemption

Where property is acquired for a land-related business, the exemption would apply to all interest incurred for the land. This would include interest on borrowings for the acquisition of the land, to pay land holding costs (like rates or insurance), or to fund the development of the land. If land held by a person qualified for the exemption, the person would be able to continue to deduct interest incurred for the land provided the existing tax rules (such as having a sufficient connection or nexus to income) allowed the deductions.

Example 8: 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 would be exempt from the proposed interest limitation rules under the proposed land business exemption and would be deductible (subject to general principles).

Period exemption applies for

The land business exemption would apply to interest incurred for land from the point where the land is held on revenue account under section CB 7. This would be from the point that a person engaged in a land-related business acquired the land for that business.

Land owned by a land business that is not held on revenue account under section CB 7

If a taxpayer acquires land other than for a land business, the land business exemption would not apply to interest incurred for the land. However, the development exemption or another exemption may apply.

Example 9

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, Because section CB 7 applies, the land business exemption would apply as soon as Jones Co purchases the land for its business and would apply for long as Jones Co continues its land-related business. The exemption would apply to interest incurred on all borrowing that is 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 would therefore not apply. However, the development exemption may apply until the new build added to the land receives a code compliance certificate (CCC). Once a CCC has been issued, the new build exemption would apply.

When any land to which the land business exemption has previously applied is sold, the land business exemption would continue to apply to the interest incurred on debt for the land for as long as the taxpayer continues to conduct a land-related business. For example, if a property was sold at a loss and debt remained, interest on the debt would continue to be deductible.

Relationship with the new build exemption from interest limitation[6]

If a property developer qualifies for the land business exemption and disposes of the property to an investor who will use it for rental property, the investor would not necessarily qualify for the new build exemption. The property would have to meet the definition of "new build land" for the investor to obtain that exemption. The definition would only be satisfied if a new self-contained residence or abode were added to the land. If the property were only remediated, that may not qualify for the new build exemption for the buyer even though the developer qualified for the land business exemption.

If the property is new build land and so qualifies for the new build exemption for the purchaser, then crossover could exist between the land business exemption and the new build exemption. This is because, where a property is acquired off the plans, both exemptions could apply at the same time to different taxpayers. For example, when a house is purchased before the house is constructed (that is, off the plans), the developer or builder could qualify for the land business exemption while they are adding a residence or abode to the land, and the purchaser could qualify for the new build exemption[7] at the same time if they have already acquired an interest in the land.

[6] For more on the new build exemption, see the "Exemption for new build land" section of this Commentary.

[7] Qualifying for an exemption, such as the new build exemption, would not automatically mean a taxpayer is allowed a deduction for interest expense. It means interest limitation would not apply if the taxpayer was otherwise allowed a deduction. For example, if someone purchased a new build to live in, they would not be allowed an interest deduction because it was private expenditure (even though the new build exemption would apply).

EXEMPTION FOR PROPERTY DEVELOPMENT

Clause 64E (proposed sections DH 4(3), DH 5(7))

Summary of proposed amendment

The proposed amendment would introduce an exemption from the proposed new interest limitation rules for one-off developments undertaken to create new build land.

Application date

The proposed amendment would come into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Key features

Proposed new section DH 4(3) would introduce the development exemption. This is an exemption from the interest limitation rules for interest a person incurs on an undertaking or scheme involving developing, subdividing or building to create new build land. Unlike the land business exemption,[8] the development exemption would apply to a person even if section CB 7 does not apply to the land.

If the development exemption applies, then all interest incurred for the land being developed would not be subject to the interest limitation rules. The interest would be deductible provided it was deductible under existing tax rules. This includes interest incurred on debt for the subdivision, development or erection of a building on the land, as well as interest incurred to fund the payment of costs associated with holding the land (such as rates or insurance).

The exemption would apply from the commencement of the undertaking or scheme for the development, subdivision or building work and end on the earlier of:

- the person disposing of the land
- the development project ceasing (that is, if the project is abandoned), or
- the land becoming "new build land".

Land would generally become "new build land" when a code compliance certificate (CCC) is issued for a new build added to the land. Once land has become "new build land", the new build exemption would apply to the land instead of the development exemption.

Detailed analysis

The aim of the development exemption is to ensure the proposed new interest limitation rules do not disincentivise investments in new housing supply. The development exemption is intended to apply to taxpayers who do not qualify for the land business exemption but who build, develop or subdivide land to create new build land.

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[8] For more on this, see the "Land business exemption" section of this Commentary.

Undertaking or scheme

The proposed exemption would apply if the land is 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) would apply. An undertaking or scheme is a plan, design or program of action devised to attain some end result. For this development exemption, it would be sufficient to demonstrate a coherent plan or purpose that involves a series of steps to create new build land.

The exemption would apply once the development undertaking or scheme begins. The point at which that occurs would be determined under current principles.[9] It would not matter if the land is not sold once the development is completed – the development exemption could still apply – but once a new build added to the land received its CCC, the development exemption would cease and the new build exemption would apply instead.

> **Example 10**
>
> Anika owns Anika Rentals Ltd (ARL), which owns and manages a large number of residential rental properties. ARL owns a large section that it decides to subdivide and build new houses on. The land business exemption would not apply to this section.
>
> The development exemption would start once ARL's undertaking or scheme to subdivide the land begins. For example, it may start once ARL 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.

Development, building, and subdivision

The existing meanings of "development", "building" and "subdivision" that apply for the land sale rules would also apply for the development exemption. These terms would include the following types of activities:

- making improvements to land, for example, clearing the land, so a dwelling can be added, or installing power or water on the site
- building a house, converting a single house into multiple flats, converting a commercial or industrial property to a residential property, or relocating a house onto the land, and
- dividing one large piece of land into multiple pieces of land.

> **Example 11**
>
> Aroha owns a property investment and rental company, Living Co. Living Co owns a piece of land that has an existing rental property on it. It decides to build a house to rent to another tenant.
>
> The existing rental property is an existing build that would not qualify for an exemption from interest limitation. The land was acquired before 27 March 2021, so the interest deductions for the portion of the land with the existing build on it would be phased out from 1 October 2021.
>
> Living Co is not in the business of developing land, so the portion of the land that it develops would not qualify for the land business exemption. However, interest deductions for this part of the land would qualify for the development exemption once the building/development undertaking or scheme starts on the land. This is because these activities have the purpose of creating a new residence. The new house Living Co is building would qualify for the development exemption while the development/building is taking place and

[9] See, for example, IS 20/08 from [35] and QB 15/04 from [39].

would then transition to the new build exemption once the new house's CCC is issued. Living Co would be allowed to deduct all the interest incurred for the land and development while the exemptions applied.

Purpose of creating new build land

The development, building, or subdivision would have to have the purpose of creating new build land. If it does not, then the development exemption would not apply to the land. Remediation activity would not qualify for the development exemption if it does not result in new build land.

The proposed definition of "new build land" is in proposed new section DH 5(7). It is set out in more detail in the "Exemption for new build land" section of this Commentary. The most important aspect of the definition is that at least one new self-contained residence or abode must be added to the land, whether by adding new buildings to the land or converting existing buildings on the land so that they meet the requirements of the definition.

The definition of new build land requires a CCC to have been issued for the new build on or after 27 March 2020. The development exemption would apply while a scheme or undertaking is taking place, before a CCC is issued.[10]

No denial of interest

If the exemption applies, the proposed new interest limitation rules would not apply and therefore none of the interest incurred would be denied a deduction under those rules. Whether the interest would be deductible would depend on whether it is deductible under existing tax rules, for example, whether a sufficient nexus exists with assessable income.

Example 12

- Amal has engaged a building firm to build a house on an empty piece of land. Amal intends to use this new build as a rental property in the future. In these circumstances, the development exemption would apply, but it is doubtful that the interest incurred by Amal for the development activity would be deductible unless there is a nexus with a 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 has engaged in development activity and would be entitled to the development exemption from the interest limitation rules, she has not met the requirements to obtain an interest deduction – there is no nexus to an income-earning activity.

When the development exemption ceases

The development exemption would apply until the earlier of the land becoming new build land, the development activity ceasing (that is, the project being abandoned), or the property

[10] An exception applies for new builds that were formerly hotels or motels. For these new builds, the development exemption (if it applies) would continue up until the point the hotel or motel conversion is recorded by a local authority or building consent authority as having been completed on or after 27 March 2020. After the conversion is recorded, the development exemption would cease and the new build exemption would start to apply.

being disposed of. Once the property becomes new build land, it would transition to the new build exemption.[11]

Example 13

Romy has engaged in sufficient development activity on her land to obtain the development exemption. She is creating a new self-contained residence. The development exemption would apply to the land while Romy is completing the development and building of the new self-contained residence. Her interest would be deductible if the general deduction criteria set out in existing tax rules are met. Once a CCC is issued, the development exemption would end, and Romy's property would transition to the new build exemption.

If a property is disposed of and a balance remains on the loan for the property (for example, if the property is sold at a loss), the interest would not continue to be deductible after the property is disposed of.

Example 14

Living Co owns a number of rental properties. It buys a house and land package. Once the house is built, Living Co intends to rent it out as an investment property. Once activity starts on the development, Living Co would qualify for the development exemption. As the build progresses, Living Co realises it needs more funds but is unable to obtain further funding through its bank. Living Co decides to sell the half-finished development to a new owner, who will be able to complete the build. The development exemption would end once the property is sold, and Living Co would no longer be able to deduct interest on the loan. The new purchaser of Living Co's development would need to meet the land business or development exemption criteria to qualify for an exemption.

[11] For discussion of the transition from the development exemption to the new build exemption, see the "Exemption for new build land" section of this Commentary.

EXEMPTION FOR NEW BUILD LAND

Clauses 64E (proposed sections DH 4(1), DH 5(1), (7)), 127(1E) and 127(10D)

Summary of proposed amendments

The proposed amendments would exempt new build land from the proposed interest limitation rules.

Application date

The proposed amendment would come into force on 27 March 2021 with application to interest incurred on or after 1 October 2021 (although the definition of new build land applies from 27 March 2021 for the new build bright-line test).[12]

Key features

The proposed amendments would introduce the "new build exemption". This exemption would ensure the interest limitation rules would not apply to prevent taxpayers deducting interest incurred in relation to "new build land" from 1 October 2021.

New build land

The definition of "new build land" is set out in proposed new section DH 5(7) and would mean:

- Land to the extent to which it has a place configured as a self-contained residence or abode, where a code compliance certificate (CCC) has been issued on or after 27 March 2020 evidencing that the new build has been added to the land. This would include land exclusively used by the residents of the new build, plus a reasonable proportion of any shared areas (for example, a reasonable proportion of a driveway shared with the residents of an older building also on the land).
- Land for which there is an agreement that a place configured as a self-contained residence or abode will be added to the land and a CCC will be issued on or after 27 March 2020 evidencing that the place was added to the land.
- Land where a hotel or motel was converted into self-contained residences or abodes, provided the conversion was completed on or after 27 March 2020 and the conversion is recorded by a local authority or building consent authority.[13]

The definition of "new build land" is relevant to both the new build bright-line test and the new build exemption.

[12] For more on the proposed new build bright-line test, see the "5-year new build bright-line test" section of this Commentary.

[13] "Building consent authority" would have the meaning given to it in the Building Act 2004.

Extent of exemption for new build land

Proposed new section DH 4(1) provides that the new interest limitation rules in subpart DH would not apply to interest incurred by a person to the extent to which the interest is incurred:

- in relation to new build land, and
- before the expiry of 20 years since the CCC was issued for the new build added to the land.

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.

Exception from the general rule for B2.3.1 modifications and hotel/motel conversions

The 20-years is counted from the date of completion if a new build's CCC was issued subject to a modification to clause B2.3.1 of the Building Code, or if the new build was previously a hotel or motel.

Background

The proposed interest limitation rules are aimed at tilting the playing field for existing residential property away from investors to first home buyers and owner-occupiers. But without new housing supply, the impact of the interest limitation rules on dampening house prices over time is likely to be somewhat limited. The proposed new build exemption is therefore aimed at ensuring the interest limitation rules do not negatively impact upon new housing supply. It does this by excluding new builds (referred to in the proposed legislation as "new build land") from the interest limitation rule for 20 years.

New build land

The definition is aimed at ensuring only clear additions to housing supply qualify, which is why self-contained residences or abodes added to land would qualify, but just adding a room to an existing house or upgrading a kitchen would not qualify.

When the exemption starts

A CCC indicates when building work was completed. It is a tool that can be used, in conjunction with other records held by local authorities and building authorities, to objectively verify whether a new self-contained residence or abode has been added to the land and can be used by both Inland Revenue and taxpayers. Therefore, the new build exemption generally starts – and the 20-year exemption period is counted – from the point a CCC is issued for a new build.

Exception for off-the-plans acquisitions

Off-the-plans acquisitions are an important source of funding for property developers. Sometimes, deposits for new builds acquired off the plans are debt-funded, so may result in the person acquiring the new build incurring interest before a CCC is issued for the new build. A special rule is therefore proposed for new builds acquired off the plans, so that a taxpayer who acquires such a new build can access the exemption from the date they enter into an agreement to acquire it. If the interest would be deductible under existing tax rules, then interest may be deducted from the date of acquisition for new builds acquired off the plans.

Exception for hotel and motel conversions

The definition of new build land would also cover situations where hotel or motel units are converted to residential accommodation. Since hotel and motel units are used for short-stay accommodation, and often already have some cooking facilities and bathrooms, less work may be required to convert them into places suitable for long-term accommodation compared to other conversions (for example, conversions of office blocks into apartments). As a result, a CCC may not be issued. Where this is the case, the proposed new build exemption would apply from the date that the local authority or building consent authority records indicate the conversion was completed.

When the exemption ends

The proposed new build exemption would need to apply for long enough that it does not discourage a person from making an initial investment in a new build, while also applying for a short enough period that it does not undermine the objective of the interest limitation rules. Different application periods were considered, including a 10- or 20-year exemption and/or potentially applying the exemption in perpetuity for the first owner of a new build.

A shorter application period may reduce the likelihood a person would invest in a new build at all. The lack of interest deductions could reduce the attractiveness or viability of investing in a new build when compared with other investments, such as commercial property.

A longer application period would mean more properties would be exempt from interest limitation for a longer period. The longer the exemption applies for, the less effective the interest limitation rules are likely to be at dampening house price inflation over time. This is because, as more new builds are created, a greater proportion of housing stock would become eligible for the exemption.

An exemption that applies for 20 years was considered the most likely to balance these competing pressures.

Impact of B2.3.1 modification on exemption period

Where a CCC is issued subject to a B2.3.1 modification, then the exemption would end earlier because the 20-year period would be counted from the date the building work to add the new build to the land was substantially completed.

Clause B2.3.1 of the Building Code concerns the durability of a building once it is completed. Normally the period for which a building is durable is counted from the date a CCC is issued for building work. However, where a CCC is significantly delayed (normally by more than 5 years), the CCC will often be issued subject to a B2.3.1 modification. The effect of a B2.3.1 modification is the durability period for the building is counted from the date the building work for the building was substantially completed, which will be a number of years before the CCC was issued.

The purpose of the B2.3.1 modification rule is to ensure there is no tax benefit from significantly delaying the issuance of a new build's CCC.

Detailed analysis

The proposed new build exemption would apply to all owners of new build land for 20 years.[14]

New build land

The new build exemption would apply to interest incurred in relation to "new build land". "New build land" is defined in proposed new section DH 5(7).

Table 1

Proposed provision	New build land would include:	Analysis
DH 5(7)(a)	Land, to the extent to which the land has a place configured as a **self-contained residence or abode**, if a **CCC** has been issued **on or after 27 March 2020** which shows the place was added to the land.	This is expected to be the most common type of property that would qualify as "new build land". It is where a new build is added to the land and receives its CCC on or after 27 March 2020. "To the extent" means the land would have to be apportioned if it has both a new build and non-new build on it. It is proposed that existing tax apportionment principles would apply.
DH 5(7)(b)	Land **exclusively used** by residents of a **new build**.	This is intended to cover both the floor area of the new build itself, as well as any outdoor areas that are exclusively used by the new build. For example, if there is an outdoor garden area that is only used by residents of a new build (and not by the residents of any other residences on the property), then those spaces would qualify as new build land as well.
	A reasonable proportion of shared areas of land appurtenant to a new build.	This is intended to cover any areas of the land that are shared by a new build and a non-new build. For example, a shared driveway or garden area. If a new build shares a driveway with a non-new build, then a reasonable proportion could be 50% of the land area covered by the driveway.
DH 5(7)(c)	Land for which there is an **agreement** that a **new build will be added to the land** and **a CCC will be issued on or after 27 March 2020** confirming the place was added to the land.	This provision is intended to ensure that interest may be deductible from the date of acquisition for new builds acquired off the plans. A CCC would not need to have been issued for an off-the-plans new build to qualify for the exemption. Note that even if the exemption from the interest limitation rules applies, the interest

[14] Except for new builds acquired off the plans, for which the proposed exemption could apply for slightly longer than 20 years.

Proposed provision	New build land would include:	Analysis
		can only be deducted if it is deductible under existing tax rules.
DH 5(7)(d)	Land that was **previously a hotel or motel**, to the extent to which a hotel or motel is **converted into** places configured as **self-contained residences or abodes**, provided this conversion is recorded in the records of a local authority or building consent authority as having been **completed on or after 27 March 2020**.	This provision would apply to former hotel and motel units that are converted into new builds. The conversions need to be completed on or after 27 March 2020, and the conversion needs to be reflected in the records of a local authority or building consent authority for the exemption to apply. The record could be in the form of a building's use changing in the records, or the rates that apply to the land switching from commercial rates to residential rates.

The new build referred to in proposed new section DH 5(7)(a) must receive its CCC on or after 27 March 2020, confirming the new build has been added to the land. The acquisition date of the land is not relevant to whether land can qualify for the new build exemption – instead, it is the date a new build's CCC is issued that is important.

Example 15: 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 would qualify 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 the application of the new build exemption.

New builds do not have to be constructed out of new material or on-site, and they can include modular or older homes that are relocated. As long as the new build is self-contained and receives its CCC on or after 27 March 2020 confirming it has been added to the land, the land would qualify as new build land.

Example 16: New build constructed off-site

Sandy has a tiny home constructed off-site that is made 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. As the tiny home is self-contained and received its CCC after 27 March 2020, Sandy's land would qualify as new build land.

A place would only qualify as a new build if it is self-contained. This means the new build would need to contain its own cooking and bathroom facilities and have its own entrance. The entrance could be from a shared accessway – for example, a hallway shared by a block of flats in the same building.

Example 17: Sleepout without kitchen and bathroom facilities

Kate owns residential land with an existing dwelling on it. She adds a sleepout to the property, which she intends to rent out, behind the existing dwelling. The sleepout can function as an extra bedroom, but it does not have its own kitchen and bathroom. Anyone staying in the sleepout would have to use the kitchen and bathroom located in the existing dwelling. Having no kitchen and bathroom means the sleepout is not self-contained and is therefore not considered a new build. The land attributable to the sleepout does not satisfy the definition of new build land.

Example 18: Sleepout converted to self-contained residence

Assume the same facts as example XX. Six months later, Kate renovates the sleepout and adds a kitchen and bathroom. The building work receives its CCC on 3 March 2021. As the sleep-out is now self-contained, and it received its CCC after 27 March 2020, it would qualify as a new build. The land the new build is on, any land used exclusively by the residents of the new build, and a reasonable proportion of any shared areas, would be considered new build land. The remainder of the land (attributable to the existing dwelling) would not be considered new build land.

Exemption applies for 20 years

Proposed new section DH 4(1)(b) provides that the exemption would apply to interest incurred before the date that is 20 years after the earliest of the following dates:

- a CCC is issued for a new build (subparagraph (i))
- a hotel or motel conversion is completed as recorded by a local authority or building consent authority (subparagraph (ii)), or
- building work to add a new build to the land is recorded as substantially completed by a local authority or building consent authority, if the CCC for the new build was issued subject to a B2.3.1 modification (B2.3.1 modification rule) (subparagraph (iii)).

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 that 20-year period would qualify for the exemption. This would include the initial owner and any subsequent purchasers within that period.

Example 19: New build receives CCC

Penny acquires an already constructed townhouse in Petone that received its CCC on 24 October 2021. Under proposed new section DH 4(1)(b)(i), the new build exemption from the interest limitation rules would apply to interest incurred in respect of the townhouse for 20 years from this date. Penny would be able to deduct interest incurred in relation to the townhouse from the date title for the land is registered to her.

Immediately after acquiring the townhouse, Penny rents the property out to Graham and Claire as a long-term residential rental property. Penny holds onto 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 would be able to deduct interest for the townhouse while the exemption applies, which is until 23 October 2041. From 24 October 2041 onwards, Penny would not be able to deduct interest for the property. This is because the new build exemption would cease to apply, and she would be denied a deduction for the interest under the interest limitation rules.

Example 20: 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 configured as self-contained residences or abodes. 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 as having been completed on 24 October 2021 in the authority's records. Under proposed new section DH 4(1)(b)(ii), the new build exemption would apply to Haydn's units for 20 years from this date, so until 23 October 2041.

Example 21: 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 would be 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 in respect of the portion of the land he is developing under the development exemption.

Although the building work for the new build is substantially completed by 24 October 2021, Rip decides he probably wants to sell the property sometime in the next ten years, so he 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 would be 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), under proposed new section DH 4(1)(b)(iii). This means that Rip would gain no tax advantage by delaying the CCC for his new build. The new build exemption would still end on 23 October 2041, even though the CCC was not issued until 24 October 2029.

Example 22: Office block conversion with new builds sold within 20 years

Sandra owns an office block that she has decided to convert into 10 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 time period covered by this example.

Sandra and Sean would be able to 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), because the new build exemption would apply.

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

Exemption applies to interest incurred in relation to new build land

The effect of the new build exemption applying would be that the interest limitation rules in proposed new subpart DH would not apply to deny interest deductions. However, this does not mean that interest for a new build would automatically be deductible. The interest would have to be deductible under existing tax rules. If the interest would not be deductible under existing tax rules, then the interest could not be deducted.

The interest that may be deducted if the exemption applies, and provided a deduction is allowed under existing tax rules, would include interest on loans to:

- acquire the land a new build is on,
- construct or install a new build on the land,
- pay for things like insurance and rates, and
- renovate, maintain, or repair a new build.

Example 23: Exemption applies to all interest for new build land

Stephanie owns land that qualifies for the new build exemption. The land is always rented out.

During the period the exemption applies, she decides to add a new deck to the new build on the land, as well as a new shared outdoor patio area. Stephanie would be able to deduct the interest she incurs on the loan she takes out to add the deck and outdoor patio area.

Ten years after the new build receives its CCC, Stephanie decides to repaint it, as the initial painting was not done very well. She takes out another loan to pay for repainting the new build. The interest she incurs on that loan would also be deductible.

If Stephanie is still incurring interest in relation to the new build land after the exemption expires, she would not be able to deduct that interest because the interest limitation rule would then apply.

Apportionment required where land is only partially new build land

If interest relates to land with both a new build and a non-new build, then only part of the land would be considered new build land. In these circumstances, the taxpayer would have to apportion the interest between the new build land and the non-new build land. Only interest incurred in relation to the new build land would qualify for the exemption.

Example 24: 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.

Viv and Adrian acquire 1500m2 of land in Kaitaia. The land has a 1970s standalone house (non-new build), as well as two new build townhouses. They take 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 1500m2 is used as follows:

- 400m2 is used exclusively by the non-new build
- 800m2 is used exclusively by the new builds, and
- 300m2 is a shared outdoor area.

After apportioning the shared outdoor area:

- **500m2 is not considered new build land.** This is the 400m2 used exclusively by the non-new build, plus one third of the shared outdoor areas (1/3 x 300m2 = 100m2).
- **1000m2 is considered new build land.** This is the 800m2 used exclusively by the new builds, and two thirds of the shared outdoor areas (2/3 x 300m2 = 200m2).

It would be reasonable for Viv and Adrian to deduct two thirds of the interest they incur in relation to the land, because two thirds of the total land area (1000m2 of the total 1500m2) is attributable to the new builds. One third of the interest they incur would not be deductible, because it would be attributable to the non-new build portion of the land.

Relationship with other exemptions from interest limitation[15]

Development exemption

The proposed development exemption would apply to a taxpayer who adds a new build to their land and would last until the earlier of when the land becomes new build land or is disposed of. Once the land becomes new build land, the new build exemption would apply.

> **Example 25: 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 would qualify for the development exemption.
>
> After construction is complete, the new builds receive their CCCs. At this point, the development exemption would cease to apply to the land, and instead the new build exemption would start to apply. The new build exemption would 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 would continue to apply to the land, but it would only apply for another 17 years – the 20-year exemption period would not reset when the land is sold.

Land business exemption

If the land business exemption applies, the new build exemption would not be relevant for that taxpayer.

Exemptions could apply concurrently for new builds acquired off the plans

For new builds acquired off the plans, the new build exemption could apply concurrently with the development or land business exemptions. This would be for both the taxpayer adding the new build to the land and the taxpayer acquiring the new build off the plans.

> **Example 26: Exemptions apply concurrently for land business taxpayer and purchaser**
>
> Neo and Archie own a large property development business, Neo-Archie Homes Ltd, which specialises in building property that is sold off the plans during construction. They acquire some former farmland in South Wairarapa, which they intend to subdivide and construct new builds on.
>
> Bagheera enters into an agreement to buy a new build from Neo-Archie Homes Ltd on 1 October 2021. 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.
>
> The land business exemption would apply to Neo-Archie Homes Ltd while it holds the land, because it still holds the land as part of a land-related business.
>
> Bagheera would qualify for the new build exemption from 1 October 2021, because he has acquired a new build off the plans. He would be able to deduct interest from that date, provided he satisfies the requirements to do so under existing tax rules. The new build exemption would apply to the land until 23 October 2042, 20 years after the new build received its CCC.

[15] For more on these, see the "Exemption for property development" and "Land business exemption" sections of this Commentary.

Relevance of the residential rental loss ring-fencing rules

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

EXCEPTED RESIDENTIAL LAND – SCHEDULE 15

Clauses 64E (proposed section DH 5(3)), 127(6B), (7B), (10C), (17B), 131B and schedule 1A

Summary of proposed amendments

The proposed amendments would set out the types of land that would be "excepted residential land" and excluded from the proposed interest limitation rules.

Application date

The proposed amendments would come into force on 27 March 2021 with application on or after 1 October 2021.

Key features

Proposed new schedule 15 provides that the following types of land would be considered excepted residential land:

- Business premises (other than 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 rest home or retirement village.
- The person's main home.
- Student accommodation.
- Employee accommodation.
- Māori excepted land.

Background

The proposed new interest limitation rules would apply to disallowed residential property (DRP). DRP would include property in use as long-term residential accommodation (such as residential rental property covered by the Residential Tenancies Act 1986) or property whose structure would support long-term residential accommodation and is thus easily substitutable for such accommodation (such as homes converted into short-stay accommodation – commonly advertised on digital platforms). At the simplest level, it would include a house or apartment, regardless of whether it is used to provide long-term or short-stay accommodation.

Given this intended scope, commercial properties that are not set up to provide accommodation (for example, office buildings and shops) are not intended to be covered by proposed new 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 would 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).

Some property types are not necessarily commercial in nature, but they do not impact on the general New Zealand housing market and are proposed to be excluded from the rules. These include properties located outside New Zealand or regulated non-commercial residences only available to a particular subset of the population.

Where a given property type is not suitable for long-term residential accommodation, and cannot easily be substituted for such, or is otherwise not likely to affect house prices in New Zealand, it is included in proposed new schedule 15. Schedule 15 lists the various forms of excepted residential land that would not be subject to interest limitation.

In determining whether a property type should be outside the scope of subpart DH, the key consideration is whether the property is of a type that would normally be available for owner-occupiers. The following factors were relevant in the development of proposed schedule 15:

- *Regulatory framework and population*: Is the property subject to a specific regulatory framework? Are there well-defined rules about who can reside in the accommodation? Is this limited to a certain sector of the population? Are wraparound services mandated?
- *Physical structure and configuration*: Are the accommodation units configured so they could be occupied by a private owner-occupier as a stand-alone dwelling unit?
- *Unconditional occupation*: Can a person occupy the residence indefinitely, or is their occupation conditional on factors other than a tenancy (for example, holding an employment position)?
- *Incentive for, and barriers to, conversion*: Would exclusion of a particular category incentivise the conversion of existing residential property into this type of accommodation? What are the barriers to this conversion process? For example, is the existence of a regulatory framework a significant barrier to conversion?

Detailed analysis

Proposed new section DH 5(2)(b) provides that land would not be considered DRP for the interest limitation rules to the extent to which it is "excepted residential land". Proposed new section DH 5(3) defines "excepted residential land" as land to the extent to which it is described in proposed new schedule 15.

The schedule lists the different types of land and property that would be excepted from the interest limitation rules. Note that these land or property types would be 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 would have to be made on normal tax apportionment principles.[16]

Main home (clauses 1 and 6)

Clauses 1 and 6 of the schedule provide that a person's main home would be excepted from the interest limitation rules. This would rely 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.

Proposed clause 6 is intended to permit 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 would also apply to a non-accommodation income-earning use of the main home – for example, a workshop or a contractor's home office.

Proposed clause 1 is intended to mirror 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 27: Main home

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

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

Tane's Wellington property is his main home and would not be subject to interest limitation under subpart DH. However, the proportion of his interest expense 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 would be a DRP.

An exception from the interest limitation rules in subpart DH does not mean that interest deductions would automatically be available for the main home. Other requirements in the Income Tax Act 2007 would 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 would mean 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 27 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 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 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, and the remaining 70%

[16] For more on this interaction, see the "Definition of disallowed residential property" section of this Commentary.

is non-deductible due to the private limitation. Tane would be able to 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 DRP 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 (non-LTC) companies would not have access to the main home exception.

Trusts are generally opaque, but it is not uncommon for people to structure their homes in trusts. Therefore, proposed clauses 1 and 6 contain an additional rule for trusts. Proposed clause 1 refers to existing section CB 16A(2), which provides that a property can be the main home 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. It is intended that clause 6 would apply in similar circumstances to ensure 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.

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 should qualify for the main home exception. Thus, the carve-out from DRP would only apply to the part that is the main home. Other properties on the same title would continue to be DRP and subject to interest limitation under proposed subpart DH. This would be the same result as if the multiple units or properties were on separate legal titles.

Example 28: Multiple residences

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 her interest expense 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)

Proposed clause 1 of schedule 15 contains an exception for business premises.

"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.

It is proposed to use this definition for 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 would only be DRP to the extent it has a place configured as a residence or abode. If the parcel of land does not contain such a structure, it would not be 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). These kinds of property are not generally configured as residences and would therefore be unlikely to meet the basic definition of DRP, but 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 may have been reconfigured for a different purpose or be used for a non-accommodation business. For example, a villa that has been converted into a doctor's surgery or a restaurant. Such properties should qualify for the business premises exception.

Premises used for a business of supplying accommodation would not qualify for the business premises exception in clause 1 of schedule 15. This is to ensure that short-stay accommodation in a standard residential property would be subject to the interest limitation rules in the same way long-term rental property would be. An exclusion for such accommodation could have a detrimental impact on the supply of housing in New Zealand available for renters and owner-occupiers.

An exception would exist to this rule 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" above.

Businesses providing accommodation on a commercial scale, such as hotels and motels, would be carved out in a specific exception in proposed clause 4, discussed below.

Farmland (clause 2)

Farmland would be excepted from the interest limitation rules under proposed clause 2 of the schedule. "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 an economic unit as a farming or agricultural business. A farming or agricultural business includes forestry, horticultural and pastoral businesses.

To be "capable of being worked as an economic unit 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. This includes the cost of capital employed and a reasonable recompense for the proprietor's labour.

However, given that the proposed new interest limitation rules would apply to land to the extent the land contains a place configured as a residence or abode, the proposed exception for farmland in schedule 15 also specifically includes such structures. This ensures that a farmhouse or workers' quarters on the farmland would not be subject to interest limitation.

Accommodation in medical and care facilities (clause 3)

Accommodation provided in hospitals, convalescent homes, nursing homes, or hospices would be 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 and would depend on the facts and circumstances of each property.

Excepted commercial accommodation (clause 4)

Accommodation provided in hotels, motels, hostels, inns, or camping grounds would be excepted from the interest limitation rules. These terms are also not defined in the Income Tax Act 2007 and would depend on the facts and circumstances of each property.

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. An exception for these listed types of accommodation would not disadvantage prospective owner-occupiers and would not generally impact the housing market.

The proposed exceptions in schedule 15 are similar to those contained in the definition of "dwelling" in section YA 1, which applies for other parts of the Income Tax Act 2007. However, unlike the "dwelling" definition, no specific exception is proposed under the interest limitation rules for boardinghouses. This is due to potential confusion regarding the meaning of a "boardinghouse", as the exceptions are intended to be relatively straightforward and easy to apply and boardinghouses are not straightforward to identify.

Many landlords may be familiar with the term "boarding house" as used in the Residential Tenancies Act 1986. This is not necessarily the same as a "boardinghouse" for tax purposes, which is not defined in the Income Tax Act 2007. Whether a property is a boardinghouse for tax purposes is based on case law and would depend on the facts and circumstances of each property.

Larger boardinghouses may be structurally similar to hostels and may not be suitable for owner-occupation, but smaller boardinghouses tend to resemble standard residential properties. Satisfying the definition of a boardinghouse for tax purposes requires some level of services to be provided, but the exact level depends on the specific circumstances.

To reduce complexity and prevent confusion, boardinghouses would not be specifically excepted from interest limitation. It is anticipated that many larger-scale boardinghouses, which tend to be more commercial in nature, would be likely to qualify as hostels, which would be excepted.

Rest homes and retirement villages (clause 5)

Rest homes and retirement villages would be excepted from the interest limitation rules. Retirement villages are defined in the Retirement Villages Act 2003 broadly as 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.[17] The Health and Disability Services (Safety) Act 2001 considers rest home care to be services provided on premises principally held out as "a residence for people who are frail because of their age".[18] Both retirement villages and rest homes are subject to regulatory frameworks set out in the above Acts.

Student accommodation (clause 7)

Certain student accommodation would be excepted from the interest limitation rules. "Student accommodation" would be defined in section YA 1 of the Income Tax Act 2007 to align with the pre-existing regulatory regime in section 5(1)(h) of the Residential Tenancies Act 1986, as follows:

- means a boarding establishment used for the accommodation of students enrolled at a registered school or premises described in section 5B of the Residential Tenancies Act 1986, and
- includes premises described in section 5B of the Residential Tenancies Act 1986 even if they are used mainly, and not exclusively, for the accommodation of students.

Broadly, section 5B of the Residential Tenancies Act 1986 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 would be available for halls of residence and hostels that are either owned by the tertiary education provider, or another entity that has a specific arrangement with the tertiary education provider, and that meet the requirements under the Residential Tenancies Act 1986.

This exception would not be available to a landlord who leases their residential rental property to students privately. This is because tertiary education providers are often located in urban centres and the properties rented by students could also be rented or occupied by other people, including workers and families. An exception for properties rented to students on the general market could therefore displace other renters or owner occupiers.

Example 29: 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 would be required by section 5B(2)). The property would not be excepted residential land and would therefore be DRP and subject to the interest limitation rules.

[17] See section 6 of the Retirement Villages Act 2003.

[18] See section 6 of the Health and Disability Services (Safety) Act 2001.

Section 5B of the Residential Tenancies Act 1986 requires that the property must be exclusively used to provide accommodation to students. However, paragraph (b) of the proposed definition of "student accommodation" provides that exclusive use as student accommodation over the course of the year would not be 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 30: Student accommodation used for other purposes over summer break

StudyLyfe is a hall of residence owner, registered with a university in accordance with the requirements of section 5B of the Residential Tenancies Act 1986. It operates a single building with 100 apartments.

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 proposed definition of "student accommodation" means the building would qualify as excepted residential land for the whole year. No apportionment is required to reflect the change of use in the summer period. StudyLyfe's building would not be subject to the interest limitation rules in subpart DH.

Employee accommodation (clause 8)

Employee accommodation would be excepted residential land and excluded from the proposed interest limitation rules. The proposed definition in section YA 1 of the Income Tax Act 2007 would define "employee accommodation" as property a person provides to their employees or other workers for accommodation in connection with their employment or service. However, it would 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 proposed definition would follow the existing exclusion for employee accommodation in the residential rental loss ring-fencing rules.

Māori excepted land (clause 9)

Clause 9 of schedule 15 would provide that "Māori excepted land" is excepted residential land and therefore excluded from being DRP. "Māori excepted land" would be 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)).
- Housing on land owned by a Māori authority (including an entity which is eligible to be a Māori authority) that is provided as a residence to its shareholders or beneficiaries. The exclusion would apply regardless of whether the entity in question owns the housing. This is intended to cover Māori communal housing forms, such as papakāinga and kaumātua housing, where such housing is on general title land and not covered by proposed new paragraph (a)(i) (paragraph (a)(ii)).
- Land acquired by a Māori authority (or entity eligible to be one) under a Treaty settlement or a post-Treaty settlement mechanism (for example, through a right of first refusal). This should include land that is subsequently transferred by the post-settlement governance entity to members of the claimant group. However, where the

land is held by a Māori authority (or entity eligible to be one) and leased to an entity that is not a subsidiary of the Māori authority, the lessee should not be able to claim the exception. In this case, only the lessor would qualify for the exception from interest limitation (paragraph (a)(iii) and (b)).

Paragraph (a)(i)

Proposed paragraph (a)(i) is intended to provide an exception for papakāinga or kaumātua housing. 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 terms in proposed paragraph (a)(i) should be understood as being synonymous with the relevant terms in the 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, the land in proposed paragraph (a)(i) would not satisfy the general definition of a DRP to begin with. In this situation, the exception would put beyond doubt that the rules in subpart DH would 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 would generally only be 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 proposed paragraph (a)(i) would be able to be sold, or rented, to a member of the general public.

It would not be straightforward for property investors to invest in Māori land or convert general title land to Māori land. Therefore, this exception would not be able to be used to avoid the application of the interest limitation rules, nor would an exception for these land categories disadvantage owner-occupiers relative to property investors.

Paragraph (a)(ii)

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

Properties on general title land that have been 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.

Therefore, proposed paragraph (a)(ii) has been designed to not apply too broadly. The exception would only apply where housing on land owned by a Māori authority, or an entity eligible to be one, is provided to a shareholder or beneficiary of that Māori authority or eligible entity.[19]

[19] Māori authorities can be trusts or companies.

However, the entity that actually manages the housing would not need to be the one that owns the land. This is how the social housing exemption in proposed new section DH 4(4) would operate too.[20]

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 reasons, for example, 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 proposed paragraph (a)(ii) would still be available.

Example 31: Māori housing on general title managed by entity that is 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 that is eligible to be a Māori authority, MATrust, which 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 houses. 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 ultimately 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 (the iwi members who benefit from MATrust), the housing would be covered by paragraph (a)(ii). This is the case even though the housing is provided by a different entity, PPKCo.

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

Paragraph (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, proposed paragraph (a)(iii) would provide that land held by a Māori authority, or 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) would be Māori excepted land and not subject to the interest limitation rules. 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

[20] For more on the social housing exemption, see the "Social, emergency, transitional, and council housing" section of this Commentary.

a leasehold interest, rather than a freehold interest. 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.

Proposed paragraph (b) provides that the exception in paragraph (a)(iii) for Treaty settlement land would not apply to leasehold interests. The exception in proposed paragraph (a)(iii) is intended to apply only to the underlying owner of the land. 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, proposed paragraph (b) is necessary to ensure that a property investor with a leasehold interest in an apartment on Treaty settlement land would not be 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 the subsidiary as the lessee. In this case, the restriction in paragraph (b) should not apply, and it is intended that both the land-holding Māori authority and the lessee subsidiary should satisfy the definition in paragraph (a)(ii) so that the land is Māori excepted land and excluded from the interest limitation rules.

Example 32: 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 long-term rental properties. LeaseCo owns the properties and derives rental income from the tenants. The Māori authority retains underlying ownership of the land. The Māori authority acquired the land in question via a post-Treaty settlement mechanism that gave it a right of first refusal over the purchase of the land; however, the Māori authority had to take out a loan to purchase the land.

The Māori authority would not be subject to the proposed interest limitation rules in relation to its loan for the land, as the land meets the requirements of the proposed definition of “Māori excepted land” (paragraph (a)(iii)) and is therefore excluded from being DRP. However, as LeaseCo is not owned by a Māori authority or an entity eligible to become one, the land would be excluded from the proposed definition for LeaseCo by paragraph (b). The land would therefore be DRP and LeaseCo would be subject to the proposed interest limitation rules in subpart DH in relation to the interest it incurs on the rental properties.

TRANSITIONAL RESIDENTIAL INTEREST

Clauses 64E (proposed sections DH 5(5), DH 7, DH 8(1), (2), DH 9) and 127(7E) and (17C)

Summary of proposed amendments

The proposed amendments would progressively deny deductions for "transitional residential interest" from 1 October 2021 to 31 March 2025. From 1 April 2025, such deductions would no longer be allowed.

"Transitional residential interest" is interest on the principal of a grandparented transitional loan, to the extent the interest is incurred for disallowed residential property (DRP) or treated as being incurred for DRP. "Grandparented transitional loans" are New Zealand dollar denominated loans first drawn down before 27 March 2021, though there are some exceptions for DRP acquired near the 27 March 2021 date.

Application date

The proposed amendments would come into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Key features

In general, interest incurred for DRP would be denied from 1 October 2021. However, interest under a "grandparented transitional loan" may qualify as "transitional residential interest". A grandparented transitional loan will generally be a loan drawn down before 27 March 2021, with some exceptions for DRP acquired near the 27 March 2021 date.

For transitional residential interest, the amount of the interest deduction denied would be progressively increased from 1 October 2021 to 31 March 2025. From 1 April 2025, deductions for transitional residential interest would no longer be allowed.

Background

The proposed interest limitation rules would apply to interest incurred for DRP, even if the DRP was acquired before the policy was announced on 23 March 2021. As such, the rules would impact some taxpayers who made decisions before the policy was announced and may face cashflow problems if interest deductions were denied in full immediately from 1 October 2021.

The provisions dealing with transitional residential interest seek to mitigate the cashflow impacts of the rules on those who purchased property before the policy's announcement. They would do so by increasing the amount of interest denied gradually from 1 October 2021 to 31 March 2025, until interest is fully denied from 1 April 2025. This is to allow taxpayers more time to adjust to the new interest limitation rules.

Detailed analysis

From 1 October 2021 until 31 March 2025, a percentage of deductions for transitional residential interest would be denied under grandparenting rules in proposed new section DH 8(2). The percentages are set out in the table below. From 1 April 2025, deductions for transitional residential interest would be fully denied (that is, transitional residential interest would be treated the same as other interest incurred for DRP).

Table 2

Period that transitional 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 would apply regardless of a taxpayer's balance date. Therefore, taxpayers who do not have a 31 March balance date may have to apply different percentages from the table above as relevant to the transitional residential interest incurred within their income year, depending on whether the interest was incurred before or after 31 March.

The portion of the interest expense not denied under proposed new section DH 8 would remain deductible provided the other requirements for deductibility are met. This may include satisfying the general permission in section DA 1 and ensuring none of the general limitations in section DA 2 apply.

Transitional residential interest

"Transitional residential interest" is defined in proposed new section DH 7 and is interest on the principal of a "grandparented transitional loan" to the extent to which the interest is incurred for DRP or treated as being incurred for DRP.[21]

Example 33: Transitional 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 ($2,500) is denied.

[21] For more on the situations where interest is treated as being incurred for DRP, see the "Grandparented transitional loans that cannot be traced" section of this Commentary.

- From 1 April 2022 to 31 March 2023, Joe incurs interest expenditure of $20,000, but 25% of this ($5,000) is denied.
- From 1 April 2023 to 31 March 2024, Joe incurs interest expenditure of $20,000, but 50% of this ($10,000) is denied.
- From 1 April 2024 to 31 March 2025, Joe incurs interest expenditure of $20,000, but 75% of this ($15,000) is denied.

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

Grandparented transitional loan

A "grandparented transitional loan" is defined in proposed new section DH 5(5). A grandparented transitional loan would generally be a loan first drawn down before 27 March 2021 for DRP. Re-drawings and additional borrowings under the same loan facility on or after 27 March 2021 do not form part of the grandparented transitional loan.[22]

The definition of "grandparented transitional loan" would also extend the grandparenting rules to two types of loans drawn down on or after 27 March 2021 – for DRP acquired before 27 March 2021 or for DRP acquired from an irrevocable offer made on or before 23 March 2021.

Property acquired before 27 March 2021

Proposed new section DH 5(5)(b) would include within the definition of a grandparented transitional loan a loan that funds the acquisition of DRP acquired before 27 March 2021 where the loan is not drawn down until on or after that date. This would be relevant where someone entered into a binding sale and purchase agreement before 27 March 2021, but settlement did not occur until on or after 27 March 2021. Interest under such loans would be transitional residential interest.

Example 34: 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 proposed new section DH 5(5)(b).

Petra's interest on her loan is $1,000 per month and would qualify as transitional residential interest. Between 1 October 2021 and 31 March 2023, $250 of her monthly interest expense would be denied, and the remaining $750 may be deductible subject to other income tax rules. Between 1 April 2023 and 31 March 2024, $500 of her monthly interest expense would be denied. Between 1 April 2024 and 31 March 2025, $750 of her monthly interest expense would be denied. From 1 April 2025, Petra would not be able to claim any interest deduction.

Example 35: Additional borrowings

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 terms of the sale and purchase agreement signed before 27 March 2021. 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.

[22] An exception to this is the proposed high water mark rules: see the "High water mark" section of this Commentary.

For tax purposes, a property is generally acquired on the date a binding sale and purchase agreement is entered into (even if some conditions still need to be met). Further information on when a property is acquired can be found in QB 17/02.[23]

Irrevocable offers made on or before 23 March 2021

Proposed new section DH 5(5)(c) would include within the definition of a grandparented transitional loan a loan that funds the acquisition of DRP if the acquisition resulted from an offer made on or before 23 March 2021 that could not be revoked by the purchaser 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. The subsection only applies to offers made on or before 23 March 2021, which was the date the proposed interest limitation rules were announced. A purchaser who made an offer on or before 23 March 2021 that was irrevocable before 27 March 2021 was legally committed to purchase the property if their offer was accepted. They are therefore in a similar position to people who purchased a property before 27 March 2021 and can also benefit from the grandparenting rules described above.

Example 36: 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. Therefore, Ted would meet the requirements of section DH 5(4)(c) and his loan to acquire the property would be a grandparented transitional loan.

Foreign currency loans

Proposed new section DH 5(5) provides that grandparented transitional loans must be denominated in New Zealand Dollars. Proposed new section DH 9 also excludes a foreign currency loan from the limited denial of interest under proposed new section DH 8(2). "Interest" for income tax purposes includes amounts calculated under the financial arrangements rules.[24] For a foreign currency loan, income under the financial arrangements rules will include foreign exchange gains and losses, which can fluctuate from year to year. These fluctuations would make the calculation of transitional residential interest for a foreign currency loan too complex. This means a deduction for interest for a foreign currency loan would be fully denied from 1 October 2021.

It is intended that a person with a foreign currency loan for DRP could refinance the loan in New Zealand Dollars and that New Zealand Dollar loan would become transitional residential interest for the period from when the New Zealand Dollar loan is drawn down.

[23] QB 17/2: Income tax – date of acquisition of land, and start date for 2-year bright-line test, [TIB Vol 29, No 4, May 2017, taxtechnical.ird.govt.nz]

[24] See paragraph (c) of the definition of "interest" in section YA 1.

GRANDPARENTED TRANSITIONAL LOANS THAT CANNOT BE TRACED

Clauses 64E (proposed sections DH 5(5), DH 7, DH 8(1), (2) and DH 12) and 127(7E) and (17C)

Summary of proposed amendment

The proposed amendment would apply where a grandparented transitional loan was used for both disallowed residential property (DRP) and other taxable uses and it is not possible to determine how much of the loan was used for DRP. The proposed amendment would deem a portion of the loan principal as having been used to acquire DRP, and interest on that portion would qualify for the grandparenting rules.

Application date

The proposed amendment would come into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Key features

Proposed new section DH 7 deals with transitional residential interest. The proposed section would effectively treat a grandparented transitional loan that cannot be traced (an untraceable loan) as being used to acquire "allowed property" before being used to acquire DRP. This would be 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, other than DRP subject to the new build, land business or development exemptions.

If the balance of the untraceable loan is less than the value of allowed property held on 26 March 2021, interest on the loan would not be subject to limitation under proposed subpart DH. If the balance of the untraceable loan exceeds the value of allowed property held on 26 March 2021, the excess would be the "notional loan principal" and treated as being used to acquire DRP. Interest on that notional loan principal would be transitional residential interest and would be denied under proposed new section DH 8 on a progressive basis between 1 October 2021 and 31 March 2025.

If a portion of an untraceable loan is treated as being used to acquire DRP, loan repayments would generally be treated as being applied to reduce the notional loan principal until it reached zero. An exception to this general rule is if the repayment is funded from a disposal of allowed property. In that case, the repayment would not reduce the notional loan principal.

Background

Generally, interest would be denied under the proposed new interest limitation rules if it is incurred for DRP. Taxpayers must apply the same general principles used in other parts of the Income Tax Act 2007 – such as the general permission in section DA 1(1)(a) – to determine whether interest is incurred for DRP.

A grandparented transitional loan would almost always be a loan drawn down before 27 March 2021.[25] It may not always be possible to trace such a loan and determine how much of the loan proceeds were used for DRP. This could be the case for grandparented transitional loans in companies, as companies did not previously need to trace their borrowings because of section DB 7. It could also be the case for a taxpayer who has used borrowed funds for both DRP and for other income-earning purposes and cannot determine retrospectively how much of the borrowings were used for DRP.

The rule in proposed new section DH 7 would only apply to grandparented transitional loans that cannot be traced. If a grandparented transitional loan can be traced, even if it is difficult or inconvenient to do so, the rule would not apply.

Detailed analysis

Grandparented transitional loans and transitional residential interest

Proposed new section DH 8(1)(a) would deny a deduction for interest incurred for DRP but would exclude interest under a grandparented transitional loan, while proposed new section DH 8(1)(b) would deny a deduction for transitional residential interest. The reason for this is because a grandparented transitional loan could have been for both DRP and other property,[26] and interest on only a portion of that loan should be denied under subpart DH. For such loans, only a portion of the interest on the loan would be "transitional residential interest" and the remaining portion would not be subject to limitation under subpart DH at all.

"Transitional residential interest" is defined in proposed new section DH 7 and would be interest under a grandparented transitional loan that is:

- interest for the loan's principal to the extent to which the interest is incurred for DRP, or
- if the loan is an untraceable loan, the portion of interest calculated by reference to a notional loan principal.

An untraceable loan is a grandparented transitional loan used for both DRP and allowed property where the portion incurred for DRP cannot be determined. The notional loan principal is an amount that the taxpayer is treated as having used on 26 March 2021 to acquire DRP. It is determined by applying proposed new sections DH 7(2) and (4).

Notional loan principal

A taxpayer with an untraceable loan would have to apply the formula in proposed section DH 7(2) to work out their notional loan principal. The formula is:

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

[25] There are two situations in proposed new section DH 5(5)(b) and (c) where a grandparented transitional loan may be drawn down on or after 27 March 2021. However, the transitional rule in proposed new section DH 7 would not apply to such loans as taxpayers would be able to trace these loans.

[26] To be a "grandparented transitional loan", the loan would have to be drawn down for DRP. A loan that was for both DRP and other purposes is still for DRP, so may still qualify as a grandparented transitional loan.

If the formula gives rise to a negative amount, it would be treated as zero. An amount of zero would mean that the untraceable loan is effectively treated as being applied entirely to allowed property, with no portion treated as being applied to DRP. The terms used in the formula are explained further in proposed section DH 7(3):

- **outstanding borrowings** is the principal of the underlying grandparented transitional loan, on 26 March 2021, to the extent it is used for both DRP and allowed property. Outstanding borrowings used for private or non-taxable purposes are excluded because interest on such borrowings has never been deductible. Taxpayers claiming a deduction for interest relating to DRP have always been required to trace their private borrowings separately from such property. Therefore, the formula only applies to borrowings for which interest expenses were deductible for tax purposes before 1 October 2021.
- **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 a new build, land business or development exemption.

To apply the formula, taxpayers would need to use the valuation rules set out in proposed new section DH 12. These rules are based on the existing valuation rules for residential rental loss ring-fencing in section EL 19.

If an untraceable loan is less than the value of allowed property held on 26 March 2021, interest on the loan would not be subject to limitation under proposed new subpart DH. If the untraceable loan exceeds the value of allowed property held on 26 March 2021, a notional amount of the loan exceeding the value of allowed property would be treated as being used to acquire DRP. Interest on that notional amount would be subject to limitation as transitional residential interest under proposed new section DH 8.

Example 37: 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:

- 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 proposed new section DH 7(2), outstanding borrowings less allowed property is:

$200,000 – $850,000 = negative $650,000

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

In summary, under proposed new section DH 7, untraceable loans for which interest expenses were previously allowed are first treated as being applied to any allowed property owned by the taxpayer before being applied to DRP. This ensures that taxpayers' borrowings for allowed property are not affected by the interest limitation rules.

Repayments

As explained above, proposed new section DH 7 may treat interest on only part of a loan as transitional residential interest, with interest on the remaining part not being subject to limitation under proposed subpart DH. The proposed section would therefore treat a single loan as two loans – one being for DRP, the other being for allowed property.

An effect of this is that when a repayment is made reducing the balance of the single loan, it is necessary to establish whether the amount treated as being for DRP or the amount treated as being for allowed property is reduced. Under proposed new section DH 7(4), the general rule is that repayments are treated as being applied to the notional loan balance first (that is, the amount treated as being for DRP), until the notional loan balance reaches zero. Once the notional loan balance reaches zero, none of the interest incurred under the (actual) loan will be transitional residential interest.

Example 38: 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 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 would not be affected by the proposed new interest limitation rules and remains fully deductible. For the remaining $20,000 interest expenditure incurred after 1 October 2021, Sanjay would have to apply the rules in proposed new section DH 7.

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

$$\$800,000 - (\$400,000 + \$200,000) = \$200,000$$

Sanjay's notional loan balance would therefore be $200,000. Interest on $200,000 of Sanjay's loan would be transitional residential interest. Interest on the remaining loan portion of $600,000 would not be subject to limitation.

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

$$200,000/800,000 \times \$20,000 = \$5,000 \text{ of transitional residential interest}$$

The amount of interest denied under proposed new section DH 8 would therefore be $5,000 x 25% = $1,250.

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

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 rule in proposed new section DH 7(4), the reduction in the loan balance would be applied against his notional loan balance. Therefore, Sanjay's notional loan principal would be reduced from $200,000 to $100,000. The amount that is transitional residential interest would be calculated as follows:

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

The amount of interest denied under proposed new section DH 8 would therefore be $4,286 x 25% = $1,071.

Proposed new section DH 7(4) contains an exception to the general rule for repayments. The exception would apply when allowed property that was held on 26 March 2021 is sold, and the sale proceeds are used to repay the outstanding borrowings. If allowed property were sold, the part of the loan treated as being for allowed property should be reduced, instead of the part treated as being for DRP. Therefore, the notional DRP loan would not be reduced.

Example 39: Repayments from sale of allowed property

Assume the same facts as in example 38, 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.

Applying the rule in proposed new section DH 7(4), Sanjay's notional loan principal would be unchanged from $200,000. The amount that is transitional residential interest would be calculated as follows:

200,000/700,000 x $30,000 = $8,571

The amount of interest denied under proposed new section DH 8 would therefore be $8,571 x 25% = $2,143.

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

Under existing law on 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 then sell the van and use the sale proceeds to go on holiday, interest on the borrowings will become non-deductible. These situations can give rise to complexity, but taxpayers can avoid this by ensuring that proceeds from the disposal of business property are only used for other busines purposes.

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

Example 40: Disposal of allowed property held on 26 March 2021

LandCo is a close company that earns income from some 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 would not be affected by the proposed new interest limitation rules and remains fully deductible. For the remaining $12,000 interest expenditure incurred after 1 October 2021, LandCo would have to apply the rules in proposed new section DH 7.

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

$600,000 – $500,000 = $100,000

LandCo's notional loan balance would therefore be $100,000. Interest on $100,000 of LandCo's loan would be transitional residential interest. Interest on the remaining loan portion of $500,000 would not be subject to limitation.

To work out its transitional residential interest, LandCo would have 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 transitional residential interest

The amount of interest denied under proposed new section DH 8 would therefore be $2,000 x 25% = $500.

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

On 1 April 2022, LandCo sells the commercial rental property and uses the proceeds to acquire an old-build DRP. Under existing tracing principles, interest on the $500,000 loan portion would be fully denied under proposed new section DH 8. Interest on the $100,000 notional loan balance would remain transitional residential interest.

HIGH WATER MARK

Clause 64E (proposed section DH 10)

Summary of proposed amendment

The proposed amendment would simplify the calculation of transitional residential interest for taxpayers with variable balance loans.

Application date

The proposed amendment would come into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Key features

The proposed amendment would introduce a transitional rule, referred to in the discussion document as a "high water mark", to simplify the calculation of transitional residential interest for taxpayers with variable balance loans (such as a revolving credit facility or an overdraft). This would mean taxpayers with such loans would not be 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) would be able to 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 would be transitional residential interest and subject to the grandparenting rules.[27] If the affected loan balance is higher than the initial loan balance on 26 March 2021, only interest on the initial loan balance would be transitional residential interest.

Background

Under the current law, a variable balance loan can result in declining interest deductions over time if the loan is used to finance a mixture of taxable and private activities. However, if a variable balance loan is used to finance only taxable activity, such as owning a residential rental property, this can provide the taxpayer with flexibility in their funding while ensuring all interest will be deductible.

Without proposed new section DH 10, a variable balance loan that finances DRP under the interest limitation proposals could result in the amount treated as a grandparented transitional loan declining faster than the underlying loan balance. That is because each loan payment (such as 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

[27] For more on this, see the "Transitional residential interest" section of this Commentary.

the amount of transitional residential interest could also reduce even if the balance of the loan, and the interest charged on that loan, remained constant.

The high water mark proposal is designed to simplify the calculation of transitional residential interest for variable balance loans. It should also prevent the need for taxpayers to refinance with a less desirable standard loan simply because of its more favourable tax treatment.

Detailed analysis

Application

Although this proposed provision is designed to apply to variable balance loans (such as a revolving credit facility or an overdraft), the application provision in proposed new 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, this provision would typically not have any practical effect as the balance would not increase above that owed on 26 March 2021. The provision specifically provides that it would only apply to those who choose to rely on it.

What interest can be transitional residential interest

Proposed new section DH 10(6) provides that a person's transitional residential interest (that is, the amount of interest incurred under the loan that would be affected by the denial of deductibility under the grandparenting rules) would be calculated based on the lower of:

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

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

Initial loan balance

The initial loan balance for most taxpayers would be the balance of their grandparented transitional loan at the end of 26 March 2021. For taxpayers who borrowed after this date to acquire a DRP that meets paragraph (b) or (c) of the definition of a "grandparented transitional loan", it is intended that the initial loan balance would be set on that date.

Affected loan balance

The affected loan balance is the actual loan balance, at any particular time, applied to DRP that qualifies for grandparenting. Under proposed new section DH 10(5), this amount requires adjustments for further amounts borrowed under the loan since the date of the initial loan balance. The purpose of these adjustments is to ensure the amount that has been spent on grandparented DRP can be determined and compared against the initial loan balance.

If the affected loan balance was above the initial loan balance for only part of a year, it is intended that separate transitional residential interest calculations would be completed for each of these periods to arrive at a single transitional 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 would add complexity, it is seen as 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.

An example of the intended calculation of the affected loan balance is included in example 41 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 between the balance of the loan and the affected loan balance would be required, which would simplify the required calculations.

Example 41: Revolving credit facility

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.

Although the balance fluctuates as he receives rent and pays expenses, by 30 September 2021 the balance of the revolving credit facility (the affected loan balance) is $480,000. Provided the affected loan balance does not go above $500,000 before the transitional period ends on 31 March 2025, Darryl would be able to calculate the amount of his interest deductions that were denied by multiplying all the interest charged on the revolving credit facility by the relevant percentage in proposed new section DH 8(2).

Example 42: 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 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 amount of transitional residential interest 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 would calculate her deductible interest by multiplying the affected loan balance of $460,000 by the interest rate and the relevant percentage in proposed section DH 6(2). The portion of the revolving credit facility used to buy the car ($70,000) is fully non-deductible.

Example 43: 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 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 on the initial loan balance of $500,000 multiplied by the relevant percentage in proposed new section DH 8(2). 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 all the interest after applying the 50% reduction 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 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 all the interest after applying the 75% reduction for the 2024–25 year.

If not for the high water mark approach, Kristina could have achieved a similar outcome by retaining $100,000 of the inheritance in a separate account and using this to pay for the renovations. This would, however, have resulted in her incurring higher net interest expenditure between 1 April 2023 and 1 April 2024 due to the interest rate charged on the revolving credit facility being higher than the interest rate paid on a savings account.

Example 44: 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 spent on repairs to the DRP.

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

Date	Transaction	Amount	Loan Balance	Affected Loan Balance	Loan Balance under s DH 10(6)	Comment
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[28]	-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		

[28] $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 current 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 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.

REFINANCING

**** A proposed amendment with this effect is not yet included in the Supplementary Order Paper. This section of the commentary is provided to summarise the policy intention.***

Summary of proposed amendment

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

Application date

A proposed amendment is intended to apply to refinancing on or after 27 March 2021.

Key features

A taxpayer with a grandparented transitional loan would have their interest deductions progressively denied by proposed new section DH 8(2). A taxpayer can refinance that grandparented transitional loan by taking out a 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 should be maintained for the second loan.

A taxpayer that has a foreign currency loan for DRP would not have a grandparented transitional loan as it would not meet that definition in proposed new section DH 5(5). Consequently, interest on such a loan would be non-deductible after 1 October 2021. If the taxpayer refinances that loan with a New Zealand dollar loan, the new loan should meet the definition of grandparented transitional loan. Interest on the New Zealand dollar loan should be eligible for limited deductions under proposed new section DH 8(2) from the date interest is incurred on the New Zealand dollar loan.

ROLLOVER RELIEF – TRANSFER OF DISALLOWED RESIDENTIAL PROPERTY

Clauses 80B, 80C and 80D

Summary of proposed amendments

The proposed amendments would provide rollover relief for certain transfers or disposals of disallowed residential property (DRP) to ensure that transitional residential interest on a grandparented transitional loan remains deductible throughout the full transition period between 1 October 2021 and 31 March 2025.

Relief would be provided for some transfers to family trusts, and to or from look-through companies and partnerships. Specific relief is proposed for transfers to trusts constituted under the Te Ture Whenua Māori Act 1993 and transfers to land trusts as part of settling claims under te Tiriti o Waitangi – Treaty of Waitangi (te Tiriti).

Relief would also be provided for relationship property settlements and transfers on death.

Application date

The proposed amendments should apply to transfers of DRP occurring on or after 27 March 2021.

Key features

Consistent with existing relief available under the bright-line test, rollover relief is proposed to apply for interest limitation purposes when DRP is transferred:

- under a settlement of relationship property, or
- following the death of the owner of the property, to an executor or administrator of the estate or to a beneficiary of the estate.

Family trusts

Rollover relief is also proposed to apply for transfers of DRP to family trusts, provided that:

- each transferor of the DRP is also a beneficiary of the trust
- at least one of the transferors of the DRP is also a principal settlor of the trust, and
- each beneficiary – except for the beneficiaries who are also principal settlors – has a family connection with a principal settlor, is a company controlled by a family member beneficiary or is a charity.

Different conditions would apply for transfers to a Māori authority (or a person eligible to be a Māori authority) as the trustee of a trust. Rollover relief would apply if:

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

– members of the same iwi or hapū, or

– the descendants of the same tipuna (living or dead).

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

Rollover relief is also proposed to apply to transfers to or from LTCs and partnerships where the persons transferring the DRP to the LTC or partnership (or acquiring it from the LTC or partnership) have ownership interests in the LTC or partnership interests in the partnership in proportion to:

- their individual interests in the property, and
- their cost base relative to the total cost base in the property.

Background

From 1 October 2021, it is proposed that new interest limitation rules would deny interest deductions for loans drawn down on or after 27 March 2021 for DRP.

Loans drawn down before 27 March 2021 would be grandparented transitional loans and interest deductions would be progressively denied over the period from 1 October 2021 to 31 March 2025 as transitional residential interest. In limited circumstances, loans drawn down on or after 27 March 2021 would also qualify as grandparented transitional loans.[29]

In general, simple refinancing should 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 would not be entitled to deduct any interest expense incurred for the property from 1 October 2021 or for the remainder of the period to 31 March 2025. This would be the case even if the economic ownership of the property remains the same.

Rollover relief may therefore be justified on equity grounds in common ownership change scenarios where *economic* ownership has not materially changed.

The policy intent is that, if the requirements for rollover relief are satisfied, the recipient should effectively step into the shoes of the transferor (the original owner with the grandparented transitional loan). This would ensure the recipient can deduct a reducing portion of their interest expense between 1 October 2021 and 31 March 2025 for the DRP. The recipient would still need 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). The recipient's maximum grandparented transitional loan should not exceed the transferor's loan balance before or at the time of the disposal – that is, if they borrow more than the transferor, the excess part of the loan would not be grandparented.

[29] For more on grandparented transitional loans and transitional residential interest, see the "Transitional residential interest" section of this Commentary.

Detailed analysis

The proposed amendments would replicate existing categories of relief available under the bright-line test for the proposed new interest limitation rules.

Rollover relief would also be provided for some transfers to family trusts and to or from look-through companies and partnerships. Specific relief is proposed for land subject to the Te Ture Whenua Māori Act 1993.

Relationship property settlements

Proposed amendments to section FB 3A provide that the section would apply when DRP is transferred on a settlement of relationship property on or after 27 March 2021. “Settlement of relationship property” is defined by existing section FB 1B(a) as a transaction under a relationship property agreement 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.

The intention is that a loan drawn down by, or transferred to, the recipient of DRP under a relationship property agreement between 27 March 2021 and 31 March 2025 would be treated as meeting the requirements of proposed new section DH 5(5), that is, it would be a grandparented transitional loan. This would be the case if the loan held by the transferor before the relationship property settlement was also a grandparented transitional loan. The recipient of the property would be able to deduct a reducing portion of their interest expense during the remaining transition period to 31 March 2025, provided the general requirements for deducting expenses are met (for example, a nexus with income exists). This transitional residential interest incurred on the recipient’s loan would only be deductible to the extent that the recipient’s loan balance does not exceed the transferor’s grandparented transitional loan balance before or at the time of the transfer.

Example 45: 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 would be a grandparented transitional loan and the interest on the loan would be transitional 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 would apply to the transfer of Dale’s share of the property to Dawn in April 2022, so the $20,000 loan would continue to be a grandparented transitional loan and Dawn would be entitled to deduct a reducing amount of interest over the remaining period to 31 March 2025.

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 of 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, provided the beneficiary is willing to voluntarily make the mortgage repayments so that they may keep the property.

Proposed amendments to section FC 9 provide that the section would apply when DRP is transferred (following the death of the owner of the property) to an executor or administrator, or to a beneficiary of the deceased's estate, on or after 27 March 2021.

The intention is that interest on a loan transferred to, or serviced by, the recipient of the property would continue to be transitional 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 proposed new section DH 5(5). This would mean that the recipient of the property may be able to deduct interest in accordance with the transitional 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 immediately before the transfer of the property. This is intended to ensure that:

- If the property was held by the deceased as a rental property, the executor or administrator (when filing the estate's income tax return) would be entitled to deduct at least some of the interest incurred by the estate between 1 October 2021 and 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 would also benefit from the transition period and would be able to deduct some of the interest on the grandparented transitional loan to 31 March 2025. This assumes the beneficiary would be repaying or taking over any loans for the property not fully repaid by the deceased's estate.

Example 46: 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 should be 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 would apply to the transfer of the property to Robin, meaning that Robin would be deemed to have a grandparented transitional loan. However, the grandparenting rules would only apply to the $40,000 required to repay Pat's bank.

Robin would be entitled to deduct a reducing amount of interest for the $40,000 over the transition period (1 October 2021 to 31 March 2025) as transitional residential interest.

Transfers to family trusts

Proposed new section FC 9B would provide rollover relief for transfers of DRP to trustees in certain situations. The section would apply when DRP is transferred to the trustees of a trust (the test trust) as a settlement on the trust or a sale to those trustees. Proposed new section FC 9B(2) would provide rollover relief for such a transfer if all the following conditions are satisfied:

- Each transferor of the DRP is also a beneficiary of the trust (paragraph (a)).
- At least one of the transferors of the property is also a principal settlor of the trust, as defined in section CB 16A(7) (paragraph (b)).
- Each beneficiary who is not a principal settlor is–
  - within four degrees of blood relationship with, or married to, or in a civil union or de facto relationship with, a beneficiary who is a principal settlor (referred to here as a "family member beneficiary") (subparagraph (c)(i))
  - a company where a 50% voting interest (or 50% market value interest, if a market value circumstance exists) is owned by a family member beneficiary (subparagraph (c)(ii))
  - a trustee of another trust that has a beneficiary who is also a family member beneficiary of the test trust (subparagraph (c)(iii)), or
  - a charity (subparagraph (c)(iv)).

To qualify as a family member beneficiary, the conditions in proposed new sections FC 9B(3) and (4) would need to be met.

Proposed new section FC 9B(3) provides that beneficiaries would have to be within four degrees of blood relationship with a beneficiary who is a principal settlor. The proposed rules are intended to mirror the existing associated person rules in sections YB 4(1), (3) and (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.

Proposed new section FC 9B(3)(b) provides that the association test would include people who are married, in a civil union, or in a de facto relationship, while proposed new section FC 9B(3)(c) would extend coverage to include stepchildren and in-laws.

Adoption is covered in proposed new section FC 9B(4)(a) to ensure that adopted children would be counted as natural children of their adoptive parents.

Proposed new section FC 9B(4)(b) mirrors existing section YB 4(4) and provides that the association test would not be met if the person cannot reasonably be expected to know both that the other person exists and they are within four degrees of blood relationship. This is designed to deal with a small minority of situations, such as when siblings are separated at a very young age and do not know of each other's existence.

Some common examples of familial relations and the degrees of blood relationship for a principal settlor are as follows (please note this list is non-exhaustive):

- One degree of blood relationship: the principal settlor's parents and children, or spouse.
- Two degrees of blood relationship: the principal settlor's grandchildren, grandparents, siblings, stepparents, stepchildren, and parents-in-law.
- Three degrees of blood relationship: the principal settlor's aunts, uncles, nieces, nephews, great-grandchildren, and great-grandparents.

- Four degrees of blood relationship: the principal settlor's cousins, great-nieces, great-nephews, and great-great-grandchildren.

Further information on how degrees of association are determined in family situations can be found in IR620.[30]

Example 47: 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. On 29 October 2022, Neo sells the DRP to his family trust. He and his son, Archie, are beneficiaries of the trust. Neo's outstanding balance of his loan, which is a grandparented transitional loan, 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 would qualify for rollover relief and therefore enable the trustee to deduct limited interest deductions until 31 March 2025. However, only interest on $400,000 of the trustee's loan would be deductible as transitional residential interest. Interest on the additional $50,000 borrowed would not qualify for rollover relief and would not be deductible. This is because the $50,000 exceeds the balance of Neo's grandparented transitional loan at the time of transfer.

Example 48: 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 transitional residential interest.

Māori family trust proposal

Proposed new section FC 9C would provide rollover relief for transfers of DRP that is subject to the Te Ture Whenua Māori Act 1993 to trustees in certain situations. The policy intent is to recognise that land subject to the 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.

Proposed new section FC 9C provides that rollover relief would be available for a transfer of DRP to a Māori authority, or 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 (subsection (1))
- each transferor is a beneficiary of the trust (subsection (2)), and
- the transferors of the DRP and the beneficiaries of the trust are all either:
  - members of the same iwi or hapū, or
  - the descendants of the same tipuna (living or dead) (subsection (2)).

[30] *IR620 A guide to associated persons definitions for income tax purposes,* available at www.ird.govt.nz

Example 49: Sale of property subject to TTWM Act to a 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 the 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, 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 would apply to the transfer of the property under proposed new section FC 9C. This means the trustees would be deemed to have a grandparented transitional loan, but the amount of that loan would be 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 would be transitional residential interest and partially deductible until 31 March 2025. Interest on the remaining $380,000 balance of the trustees' loan would not be deductible.

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

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 directly are generally the same as for someone who instead holds DRP through an LTC.

The intent is that, under proposed new section FC 9E(4)(b), rollover relief should apply to a transfer to or from an LTC when the persons transferring DRP to the LTC – or acquiring it from the LTC – are all shareholders in the LTC in proportion to:

- their individual interests in the DRP, either before or after the transfer, as appropriate (subparagraph (i)), and
- their cost base relative to the total cost base in the DRP (again, either before or after the transfer, as appropriate) (subparagraph (ii)).

Like LTCs, partnerships are also transparent for tax purposes. As for transfers to or from LTCs, the intent is that under proposed new section FC 9E(4)(c), rollover relief should apply to a transfer to or from a partnership when the group of persons transferring DRP to the partnership – or acquiring it from the partnership – are all partners in the partnership and their respective partnership interests are in proportion to:

- their individual interests in the DRP, either before or after the transfer, as appropriate (subparagraph (i)), and
- their cost base relative to the total cost base in the DRP (again, either before or after the transfer, as appropriate) (subparagraph (ii)).

Example 50: Transfer to look-through company

Mary and Bob, a married couple, are the shareholders in a look-through company, Company A. Mary and Bob jointly own an investment property in equal shares. They each have the same cost base in the property and hold 50 percent of the shares in Company A. 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 A. Company A 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 A 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 A's excess loan balance of \$50,000 does not qualify for rollover relief.

MIXED USE ASSETS

Clauses 64B and 64D

Summary of proposed amendments

The proposed amendments would integrate the proposed new interest limitation rules in subpart DH with the existing rules for apportioning expenditure in relation to mixed use assets in subpart DG.

Application date

The proposed amendments would apply from 27 March 2021.

Key features

The proposed amendments would ensure the proposed new interest limitation rules in subpart DH integrate with the existing mixed use asset rules in subpart DG.

Proposed new section DG 2(3B) would ensure that when interest subject to apportionment under sections DG 8 and DG 9 is for disallowed residential property (DRP), or an interest in an interposed residential property holder (IRP holder), the deductibility of that interest would be subject to denial under the interest limitation rules in subpart DH. This treatment would not apply to interest expenditure subject to apportionment under sections DG 11 to DG 14, as this debt is not allocable to the property under a tracing approach.

Proposed new section DG 11(2B) would ensure DRP, debt on that DRP and interest on that debt is excluded from the apportionment calculation for close companies under section DG 11.

Background

Subpart DG has two main features. First, it specifies how expenses relating to mixed use assets should be apportioned between deductible and non-deductible purposes. Second, for mixed use assets held in close companies, it also determines when interest expense should be treated as relating to a mixed use asset (including some cases where the interest expense is incurred by a person who does not own the asset). In relation to this second feature, it does not trace debt to assets, as is required for most purposes of the Income Tax Act, including the proposed new interest limitation rules. Instead, it allocates debt first to mixed use assets, and if there is not enough debt owed by the close company, it attributes debt owed by related persons to the mixed use asset.

In relation to the first feature, the proposed amendments ensure that interest expense identified under a tracing approach as relating to a mixed use asset that is a DRP is denied a deduction under subpart DH if appropriate. In relation to the second feature, the proposed amendments are intended to ensure that the same amount of debt is not allocated to different assets under different sets of rules.

Detailed analysis

When interest expenditure is subject to apportionment under sections DG 8 and DG 9 and it relates to DRP or an interest in an IRP holder, proposed new section DG 2(3B) would ensure the deductibility of that expenditure is subject to the application of the proposed new interest limitation rules in subpart DH (and not conclusively resolved by section DG 8(1)). A deduction would not be allowed for that portion of the interest expenditure identified as deductible by section DG 8(1) that would be denied under proposed new section DH 8.

This treatment would not apply to interest expenditure subject to apportionment under sections DG 11 to DG 14. Such interest expenditure 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.

Proposed amendments to section DG 11(1)(b) would clarify that the section only applies if the asset-owning close company has interest expenditure that is not traced to DRP or an interest in an IRP holder. This is because that interest expenditure would have already been allocated to those assets and could not be allocated again by section DG 11.

Proposed new section DG 11(2B) would apply where a close company has some interest expenditure that is traced to DRP or an interest in an IRP holder, and some interest that is not. The proposed provision would ensure that section DG 11 would not apply to:

- interest subject to subpart DH
- debt giving rise to that interest, and
- assets to the extent they are funded by the debt giving rise to that interest.

Example 51: Mixed use assets

RB Ltd is a close company. For the year ended 31 March 2023, RB Ltd owns a holiday home that is both a mixed use asset and DRP and a boat that is also a mixed use asset. 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 IRP holder (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 mixed use asset (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 $2,200 (being $5,500 –$3,300) x 45% or $990.

The end result is that, of RB Ltd's total interest expenditure of $8,000 incurred in the year ended 31 March 2023:

- $1,375 of interest is apportioned under section DG 8 to private use of the holiday home and is non-deductible.
- $1,125 of interest is apportioned under section DG 8 to income-earning use of the holiday home – under proposed new subpart DH, 25% of this amount is non-deductible and 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. Proposed new 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.

LOANS IN FOREIGN CURRENCY

Clauses 55B and 64E (proposed section DH 9)

Summary of proposed amendment

The proposed amendment would treat income arising from a foreign currency loan used for disallowed residential property (DRP) as exempt income.

Application date

The proposed amendment would come into force on 27 March 2021 with application to income derived on or after 1 October 2021.

Key features

Although property outside New Zealand would not be covered by the interest limitation proposals, DRP in New Zealand could still 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. Proposed new section CW 62C would treat income arising from a foreign currency loan used for DRP as exempt income.

The treatment of these foreign currency loans would therefore be consistent with New Zealand dollar loans, except they would not be eligible for the phasing out of interest deductions under proposed new section DH 8(2) and any income derived would be exempt income under proposed new section CW 62C. Note that a foreign currency loan would not be a grandparented transitional loan so would not generate transitional residential interest.[31]

[31] For more on this, see the "Transitional residential interest" section of this Commentary.

DISPOSAL OF DISALLOWED RESIDENTIAL PROPERTY SUBJECT TO INTEREST LIMITATION

Clause 64E (proposed section DH 11)

Summary of proposed amendment

The proposed amendment would allow interest that has been denied a deduction under the interest limitation provisions to be deductible in the year of disposal of the disallowed residential property (DRP) if the disposal is taxable.

Application date

The proposed amendment would come into force on 27 March 2021 with application to disposals of disallowed residential property on or after 1 October 2021.

Key features

The proposed new section DH 11 would allow interest that has been denied a deduction under the interest limitation provisions to be deductible, subject to certain restrictions, in the year of disposal of the DRP if the disposal is taxable. This reflects that it may not be known until the year of disposal whether the disposal will be taxable and also that any taxable gain is not taxable until then.

If the amount derived on disposal of the DRP is income under the bright-line test, the amount of the previously denied interest would be treated as if it were part of the cost of the property. If this results in a net loss, the deduction for the net loss would be limited under the current rule that applies to losses from the disposal of bright-line property. Under that rule, the loss would only be able to be deducted against other taxable gains on real property. Any excess loss would be carried forward and could be deducted against other land sale gains in later income years.

If the amount derived on disposal of the DRP is income under a provision other than the bright-line test, the amount of the previously denied interest would be allowed as a deduction in the year of disposal. Where the residential rental loss ring-fencing rules apply (which would usually be the case if the property is subject to interest limitation), the interest, together with other expenditure for the property or portfolio, would be subject to those rules.

If the disposal of the DRP is not taxable, the interest previously denied a deduction under proposed new section DH 8 would remain non-deductible.

If one of the land business, development or new build exemptions applies, this proposed amendment would not apply. In that situation, the interest would not have been subject to interest limitation and would have been deductible in the year it was incurred.

Detailed analysis

General criteria

Under proposed new section DH 11, interest that was previously denied a deduction under the interest limitation in proposed new section DH 8 would be deductible in the year of disposal of the DRP only if the disposal is on revenue account (that is, any gain is taxable, and any loss is deductible).

Even where the disposal is on revenue account, the interest will only be deductible if the interest would have been deductible when incurred if proposed new section DH 8 had not applied. In other words, the interest would have to have met the general permission (section DA 1) and not been denied under the private limitation or another limitation (section DA 2).

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 section DH 8 would remain non-deductible.

Example 52: 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. Only Jack and Aria, and their friends and family, used the bach. They did not rent it out.

Jack and Aria paid a total of $96,000 interest. They did not deduct any for tax purposes.

The amount derived on the sale of the bach would be income under the bright-line test. None of the $96,000 interest they paid would be 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 gain on sale of $50,000 would be income under the bright-line test and none of the interest would be deductible.

Interest deductible when it was incurred would not be deductible again in the year of disposal. This would include interest:

- incurred before 1 October 2021
- relating to pre-27 March 2021 property and debt that was allowed partial deductions under the grandparenting provisions, and
- that was deductible because an exemption from the interest limitation rules applied (the land business, development, or new build exemptions).

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 would also not become deductible in the year of disposal. Instead, it would remain part of the excess residential deductions carried forward and would only be deducted as allowed under the residential rental loss ring-fencing rules.

If the disposal of the DPR was taxable, different rules would apply depending on whether the disposal was taxable under the bright-line test (sections CB 6A or CZ 39) or another provision.

Disposal taxable 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 previously denied interest would be 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 would be limited under the anti-arbitrage rule that applies to losses from the disposal of bright-line property.

The anti-arbitrage provision (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 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 it was not. To address this, proposed new section DH 11(1) provides that, for bright-line disposals, the previously denied interest is treated as 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.

Example 53: Sale of rental property subject to the bright-line test

Assume the same facts as example 52, 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. Proposed 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. If this is the only property Jack and Aria sold that year, the deduction would therefore be limited to $750,000 (resulting in no net income to be taxed or loss deducted). This would mean only $50,000 of the disallowed interest would be deductible. The excess amount of $46,000 would be carried forward and applied against any taxable land sale gains Jack and Aria have in later years.

Disposal taxable under another land sale provision

If a disposal is taxable under a provision other than the bright-line test, the same level of concern with arbitrage does not exist. The character of the disposal (non-taxable or taxable) cannot be determined by choosing the time of the disposal. In this case, the anti-arbitrage rule would not apply, but the residential rental loss ring-fencing rules would (proposed new section DH 11(2)).

If a property disposal was taxable under a provision other than the bright-line test, the interest would retain its character as interest (and not be recharacterised as part of the cost of the property). Any gain on sale would be taxable and any loss deductible. The previously denied interest would be deductible, but it would be subject to the residential rental loss ring-fencing rules.

Application of the residential rental loss ring-fencing rules would mean the previously denied interest and any other expenditure would be netted against the income from the property or portfolio. If these total deductions exceeded the income, the treatment of the excess deductions (that is, the net rental loss from the property or portfolio) would depend on whether the residential rental loss ring-fencing rules were being applied on an individual property or portfolio basis.

If the rules were being applied on a portfolio basis (that is, together with other properties), the net portfolio rental loss in the year of a taxable disposal would be deferred and carried into the next income year to be deducted against later residential property income. However, if the taxpayer was applying those rules on an individual property basis, the net rental loss would usually be fully deductible in the year of taxable disposal.

INTERPOSED ENTITY RULES

Clauses 64E (proposed sections DH 5(6), DH 6, DH 8, DH 12) and 127(10B), (16D)

Summary of proposed amendments

The proposed amendments would introduce interposed entity rules to deny interest deductions for a person who indirectly holds disallowed residential property (DRP) through an interposed residential property holder (IRP holder).

Application date

The proposed amendment would come into force on 27 March 2021 with application to interest incurred on or after 1 October 2021.

Key features

It is proposed to introduce interposed entity rules to support the integrity of the proposed new interest limitation rules. The rules would deny interest deductions for a person who indirectly holds DRP through an IRP holder. An IRP holder for a person can be a company or a trust that is not a unit trust.[32] The proposed interposed entity rules would not apply to look-through companies (LTCs) or to partnerships that have DRP.

The proposed interposed entity rules are based on the residential property percentage. If a close company, other company, or trust has a residential property percentage over the relevant threshold, that entity would be an IRP holder. The residential property percentage is the value of the entity's DRP (excluding property subject to the new build, land business or development exemptions and, in the case of close companies, certain mixed-use assets) as a percentage of the value of the entity's total assets. The relevant threshold of the residential property percentage for determining if an entity is an IRP holder for a person differs depending on whether the entity is a close company, other company, or a trust.

Where a person has voting interests or market value interests in a company, the company would be an IRP holder for that person if the company has a residential property percentage:

- for close companies, of more than 10% at the end of a quarter in the income year, or
- for other companies, of more than 50% at any time in the income year.

Where the person is a direct or indirect beneficiary of a trust (other than a unit trust), the trustees of that trust would be an IRP holder for that person if the trust has a residential property percentage of more than 10% at any time in the income year.

If a close company is an IRP holder for a person, the interest incurred by the person as the owner, or to become the owner, of the IRP holder would be limited in proportion to the close company's residential property percentage.

If a company, other than a close company, is an IRP holder for a person, all interest incurred by the person for legal or beneficial ownership of the company would be denied.

[32] Unit trusts are treated as companies for tax purposes.

If a trust (other than a unit trust) is an IRP holder for a person, all interest incurred by the person for legal or beneficial ownership of the trust would be denied.

Background

Interposed entity rules are required to support the integrity of the proposed new interest limitation rules. Without such rules, people could borrow for DRP indirectly through an IRP holder and obtain deductions for interest incurred on money borrowed to acquire shares in, or to become a beneficiary of, the IRP holder.

The use of interposed entity rules as an integrity measure is an existing feature of the Income Tax Act 2007. For example, subpart EL contains interposed entity rules to support the integrity of the residential rental loss ring-fencing rules.

Detailed analysis

Deduction denied

Proposed 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 in relation to the legal or beneficial ownership of an IRP holder.

The proposed section would apply not only to interest incurred to become an owner but also to interest incurred in relation to the legal or beneficial ownership of an IRP holder. This ensures that if a person borrows money to acquire an ownership interest and later refinances the initial borrowing, the interest limitation rule would apply to the later borrowing.

Interposed residential property holder

"Interposed residential property holder" is defined in proposed new section DH 5(6). An IRP holder for a person may be one of three types of DRP holders:

- A close company[33] for which the person has voting interests or market value interests and the company has, at the end of each quarter in the income year, a residential property percentage of more than 10%.
- A company that is not a close company for which the person has voting interests or market value interests and the company has, at any time during the income year, a residential property percentage of more than 50%.
- 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, a residential property percentage of more than 10%.

[33] A close company is a company that has five or fewer natural persons or trustees whose combined voting interests, or market value interests, in the company is more than 50% (treating all associated natural persons as one person).

Residential property percentage

"Residential property percentage" is defined in proposed new section DH 6(1). It is the amount, for an IRP holder, calculated using the following formula and expressed as a percentage:

$$\text{disallowed assets} \div \text{total assets}$$

"Disallowed assets" and "total assets" are defined in proposed new sections DH 6(2)(a) and (b):

- "Disallowed assets" means the value of the IRP holder's DRP but excluding property subject to the new build, land business and development exemptions[34] or, for a close company, property subject to the mixed use asset rules in subpart DG.
- "Total assets" means the total value of the IRP holder's property excluding, for a close company, property subject to subpart DG.

Proposed 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 "disallowed assets" and "total assets" would be calculated by applying the look-through rule in s YC 4. The company would be treated as the ultimate shareholder, and the assets held by the subsidiary companies would be attributed to that company in proportion to its ownership interests in the subsidiary companies. For example, a person holds shares in Holdco Ltd and Holdco holds 50% of the shares in Subco Ltd. If Subco Ltd owns DRP and other assets, 50% of SubCo's DRP and other assets would be attributed to Holdco Ltd when calculating Holdco's residential property percentage.

Valuation of property for residential property percentage formula

Proposed new section DH 12 contains rules for valuing property for subpart DH. These rules would apply to determine the value of land and other property for the residential property percentage formula.

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 own DRP. This concern is reflected in the 10% residential property percentage threshold and quarterly calculation requirement for close companies.

10% threshold

Proposed new section DH 5(6)(a) provides that a close company would be an IRP holder for a person if the person has voting interests or market value interests (generally, shares) in the company and the company has, at the end of a quarter in the income year, a residential property percentage of more than 10%.

The purpose of the proposed interposed entity rules is to limit interest deductions where borrowed money has indirectly funded DRP. In principle, this would justify having no

[34] For more on these exemptions, see the "Exemption for new build land", "Land business exemption" and "Exemption for property development" sections of this Commentary.

residential property percentage threshold (that is, the rule would apply if the interposed close company had *any* DRP). However, as the proposed interposed entity rules would create compliance costs, a *de minimis* threshold of 10% applies so that shareholders in close companies with only very small amounts of DRP as a proportion of their total assets would not need to apply the rules.

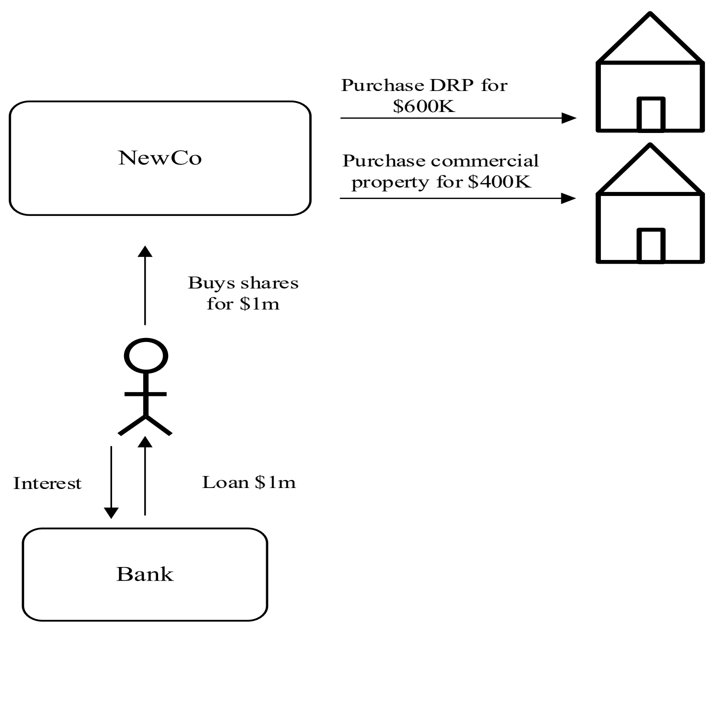
Quarterly calculation

The greater the frequency of the residential property percentage calculation, the greater the accuracy of the calculation in limiting interest deductions on borrowings that indirectly fund DRP. The requirement to calculate the residential property percentage at the end of each quarter strikes a balance between the greater accuracy of a daily calculation and the potential for significant inaccuracy, and possibly abuse, of an annual calculation.

Proposed section DH 8(3) contains the quarterly calculation for determining the amount of interest denied for a person who is an owner of an IRP holder that is a close company. The provision would apply to interest incurred by the person as the owner, or to become an owner, of the IRP holder. The proposed formula multiplies the amount of the interest incurred by the person in a quarter by the residential property percentage of the IRP holder at the end of the quarter. The total of the amounts denied in each quarter is the amount of interest denied for the income year.

Example 54: Interposed close company rule

Figure 1



Catherine borrows $1m from Bank. She sets up a company, NewCo, and is issued 1000 shares at $1k per share. NewCo buys a DRP for $600k and a commercial property for $400k using the share issuance proceeds.

Under proposed new sections DH 6 and DH 8, NewCo's disallowed assets would be $600k and its total assets $1m. NewCo's residential property percentage would therefore be 60% at the end of each quarter of the income year.

NewCo would be an IRP holder for Catherine under proposed new section DH 5(6)(a).

Applying proposed new section DH 8(3), 60% of the interest incurred by Catherine during the income year on the $1m loan used to set up NewCo would be denied.

Interposed non-close companies

Under proposed new section DH 5(6)(b), a company that is not a close company would 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, a residential property percentage of more than 50%.

Under proposed new section DH 8(1)(c), if a person incurs interest in relation to the legal or beneficial ownership of an IRP holder that is a non-close company, all interest incurred by the person would be denied. The denial of all interest incurred by the person is a simplification measure to avoid an apportionment approach like the one that would apply to interposed close companies under proposed new section DH 8(3). Although apportionment is more accurate, it would usually be much more complex for shareholders in non-close companies to apply.

The higher residential property percentage threshold of 50% should ensure that full denial would not apply if the company has modest amounts of disallowed assets. In practice, companies that do not hold DRP as a core part of their business are likely to have a residential property percentage well below the 50% threshold.

Interposed trusts

Proposed new section DH 5(6)(c) provides that the trustees of a trust (that is not a unit trust) would be 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 a residential property percentage of more than 10%.[35]

For income tax purposes, a unit trust is treated as a company.[36] 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 proposed new section DH 5(6)(a) or (b), rather than section DH 5(6)(c).

If a trustee is an IRP holder for a person, all interest incurred by the person to become a beneficiary of the trust would be denied under proposed new section DH 8(1)(c). Applying an apportionment approach, like the one proposed for interposed close companies, to an interposed (non-unit) trust would often 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 as a beneficiary of a (non-unit) trust.

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[35] As mentioned, existing subpart EL contains interposed entity rules. Those rules also provide for the possibility of an interposed trust that is not a unit trust.

[36] 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".

Look-through companies and partnerships

The proposed interposed entity rules would 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[37] 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.

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[38] 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.

LTC elections

It is possible for a close company that is an IRP holder to make an election to become an LTC. In this case, if a shareholder in that company incurred interest in relation to their ownership of the company before the effective date of the LTC election,[39] they would have applied the interposed close company rule. For simplicity, the policy intent is that if the shareholder also incurs interest in relation to their ownership of the company after the effective date of the LTC election, they would continue applying the interposed close company rule.

Accordingly, notwithstanding its LTC status, the policy intent is that an LTC will be treated as an IRP holder for a person if:

- before the effective date of the LTC election, the person was denied a deduction for interest incurred in relation to the ownership of the LTC under proposed new section DH 8(1)(c), and
- the interest denied related to borrowings that are still outstanding at the effective date of the LTC election.

[37] "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.
[38] "Partnership share" is defined in section YA 1 and means, for property, the share that a partner has in the partnership.
[39] The effective date of an LTC election is determined under section HB 13.

SPECIFIC ANTI-AVOIDANCE RULES

Clause 85D

Summary of proposed amendment

The proposed amendment would insert two new specific anti-avoidance rules to support the integrity of the interest limitation rules.

Application date

The proposed amendment would come into force on 27 March 2021.

Key features

- Proposed new section GB 53B would address situations where a change in value affects the **residential** property percentage calculation for an interposed residential property holder.
- The residential property percentage determines whether a company or trust is an interposed residential property holder for a person. If it is, interest incurred by that person may be subject to limitation.[40] A change in value that affects the residential property percentage could, for example, be due to the disposal or acquisition of disallowed residential property (DRP) before or after a calculation date.
- For proposed new section GB 53B to apply, the change in value would have to have a purpose or effect of defeating the intent and application of subpart DH. If the section did apply, the effect of the increase or decrease in value would be ignored in calculating the residential property percentage of the interposed residential property holder.
- Proposed new section GB 53C would address arrangements where a person (on-lender) on-lends borrowed money to an associated person at a lower rate of interest than the rate payable by the on-lender. For the proposed new section to apply, the associated person, or a person associated with them, would have to own DRP and the arrangement would have to have a purpose or effect of defeating the intent and application of subpart DH. If the section did apply, the amount of interest incurred by the on-lender would be limited to and calculated using the lower rate, with the higher rate being ignored.

Detailed analysis

Residential property percentage – increases or decreases in value

Proposed new section GB 53B is based on the current specific anti-avoidance rule in section GB 51B, which supports the integrity of the thin-capitalisation rules.

[40] For more on the residential property percentage and interposed residential property holders, see the "Interposed entity rules" section of this Commentary.

Proposed new section GB 53B would address situations where:

- there is a change in value that affects, or would affect, the result of the **residential** property percentage calculation for an interposed residential property 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, if a close company (that would otherwise satisfy the requirements to be an interposed residential property holder) disposes of DRP shortly before a quarterly calculation date so that it falls below the 10% residential property percentage, and therefore the rules do not apply, but then reacquires the same or similar DRP shortly after the calculation date.

If a change in value had a purpose or effect of defeating the intent and application of subpart DH, the change in value would be ignored when calculating the residential property percentage of the interposed residential property holder.

On-lending at lower rate

Proposed new section GB 53C would address 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 (for example, a close company owned by the on-lender) that either owns DRP or is associated with a person that 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 expenditure paid by the on-lender on the borrowings that, in reality, funded the DRP might not be subject to any limitation in the absence of a specific anti-avoidance rule. Without such a rule, taxpayers may be able to enter into on-lending arrangements to lower the amount of interest denied under subpart DH.

Proposed new section GB 53C would apply when an arrangement involves a person on-lending funds 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 that is the case, the amount of interest incurred by the on-lender would be limited to, and calculated using, the lower interest rate, and the higher rate would be ignored.

Example 55: 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 would be 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 under subpart DH. This is because she used the borrowed funds to derive interest income from LandCo, rather than for DRP or in relation to her ownership of an interposed residential property holder.

If the particular facts indicate that the arrangement has a purpose or effect, that is not a merely incidental purpose or effect, of defeating the intent and application of subpart DH, Zeean's interest deduction would be limited to 1% rather than 5%.

Purpose or effect of defeating the intent and application of subpart DH

Both of the proposed new specific anti-avoidance rules would 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 Act, or a part of the Act.[41] It is intended that this case law will inform the meaning and application of proposed new sections GB 53B and GB 53C.

[41] For example, see *Glenharrow Holdings Ltd v CIR* [2008] NZSC 116.

ADMINISTRATION TO SUPPORT THE PROPOSED INTEREST LIMITATION RULES

Further guidance

Residential rental property owners would have to consider and apply any new interest limitation rules in their 2022 income tax return. To support the administration and integrity of the proposed rules, additional information would be required in their return about interest incurred and interest deductions claimed for residential rental properties, as well as reasons for any exclusion or exemption claimed.

Inland Revenue will provide guidance to help taxpayers comply with the new rules should the interest limitation proposals become law.

Record keeping

No specific amendments to existing record-keeping rules are proposed. Current law would require taxpayers to keep and retain records for at least seven years after the end of the income year in which they claimed a deduction. Records to be kept include information or documents about sales, income and expenses, and assets and liabilities.

However, residential rental property owners should be aware that they might need to keep records for longer than seven years in some situations. For example, they might need records older than seven years to support their claim for interest deductions if a residential property is taxed on sale under the 10-year bright-line test and previously denied interest deductions are then allowed. They would then also have to retain those records for a further seven years.

Bright-line test changes

5-YEAR NEW BUILD BRIGHT-LINE TEST

Clauses 48, 49, 64E (proposed section DH 5(7)), and 127(1B) and (1C)

Summary of proposed amendments

The proposed amendments would introduce a 5-year bright-line test for new builds.

Application date

The proposed amendment would apply to residential land acquired on or after 27 March 2021, provided a new build was on the land when it was sold by the acquirer.[42]

Key features

The proposed amendments would introduce a 5-year bright-line test for new builds. The shorter bright-line period would apply to residential land acquired on or after 27 March 2021 if:

- the land
    - has a new build on it, and was acquired no later than 12 months after the code compliance certificate (CCC) was issued for the new build[43]
    - was acquired with an agreement in place for the construction of a new build (an off-the-plans purchase), or
    - has a new build constructed on it by the owner, and
- a new build is on the land when it is sold.

Apportionment is proposed where both a new build and an old build are on the land to ensure only the portion of the land attributable to the new build is subject to the 5-year bright-line test.

Background

The bright-line test taxes gains from residential land disposed of within a specified period after acquisition (the bright-line period).

The length of the bright-line period depends on when the land was acquired. If land was acquired on or after 29 March 2018 but before 27 March 2021, a 5-year bright-line period applies. For land acquired on or after 27 March 2021, the general bright-line period is now

[42] However, it would not apply 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.

[43] An exception exists for hotels or motels converted to residential accommodation that do not require a CCC – see the Detailed analysis discussion below.

10 years, which means land will be taxed if disposed of within 10 years of acquisition unless an exclusion[44] or the proposed 5-year new build bright-line test applies to the land.

The proposed amendments would introduce a 5-year bright-line period for new builds (new build bright-line test). This is intended to ensure the supply of new houses is not discouraged by the 10-year bright-line test.

The land would not need to be used to provide long-term residential accommodation for the new build bright-line test to apply instead of the 10-year bright-line test – for example, the property could be used as a holiday home. It would be difficult for Inland Revenue to determine how a property is used, and in most cases, properties are put to the most efficient use for the owner, either as a main home or rental accommodation.

The new build bright-line test would apply to new build land more narrowly than the new build exemption from the interest limitation rules (the new build exemption).[45] The new build exemption applies to all owners within the 20-year exemption period starting from the date the CCC is issued for the new build. The new build bright-line test, however, only applies to taxpayers who acquire the land no later than 12 months after the new build on the land receives its CCC.

Detailed analysis

Existing settings that would apply for the new build bright-line test

The following policy settings that currently apply for the 5-year and 10-year bright-line tests would also apply for the proposed new build bright-line test. Most of these settings are located in section CB 6A, while the main home exclusion is in section CB 16A.

Table 3

Setting	Explanation
The rules that determine when the property is acquired and disposed of, and when the bright-line period is counted from (section CB 6A)	The existing rules that determine when property is acquired and disposed of and when the bright-line period is counted from will continue to apply. The bright-line period will not restart when a new build is added to the land. This is even where a commercial building is converted into new builds – the bright-line period starts when the land is first acquired, not when the land first becomes residential land.
The definition of "residential land" covered by the bright-line test (section YA 1)	This includes land that has a dwelling on it, land where the owner has an arrangement to build a dwelling on the land, and bare land that may be used for erecting a dwelling under the relevant operative district plan. "Residential land" does not include farmland or land used predominantly as business premises (unless it is a business of

[44] There are exclusions for main homes, inherited property, and land transferred under settlements of relationship property – refer to sections CB 16A, CB 6A(12), FC 9, and FB 3A.

[45] For more on the new build exemption, see the "Exemption for new build land" section of this Commentary.

Setting	Explanation
	providing accommodation in a dwelling that is not the owner's main home).
The main home exclusion (section CB 16A)	The main home exclusion will continue to: • apply where a property is used as a main home, or not used as a main home for consecutive periods of 12 months or less (although changes are proposed to ensure the main home is not taxed even when more than half of the land is not used as a main home[46]) • be available to certain properties held in trust, although people cannot use the main home exclusion for multiple properties held through trusts (a continuation of current settings), and • be unavailable if it has already been used twice in the two years before the date of disposal, or if there is a regular pattern of buying and selling main homes.
Other exclusions and forms of relief (sections CB 6A, FB 3A, FC 9)	Other current exclusions and forms of relief will continue to apply, including: • transfers on death, and any subsequent disposal by the beneficiary will be exempt, and • a person who receives land under a relationship property agreement will take on the bright-line start date (the date from which the bright-line period is counted) and cost of the transferor. Additional forms of rollover relief are proposed for both the 10-year bright-line test and the 5-year new build bright-line test.[47]
Residential land withholding tax (RLWT) (subpart RL; sections 54B–54D of the Tax Administration Act 1994)	RLWT will continue to apply to taxable sales by anyone who is an "offshore RLWT person" (defined in section YA 1) – in short, a vendor who is living or established outside New Zealand.
Specific anti-avoidance rules (sections GB 52 and GB 53)	These will continue to counter companies and trusts being used to circumvent the bright-line test.
Deduction settings (sections DA 1, DA 2, DB 23 and DB 23C)	Vendors will continue to be allowed deductions for property subject to the bright-line test according to ordinary tax rules.
Loss ring-fencing (subpart EL)	Losses arising from a bright-line sale will continue to be ring-fenced and available only for use against taxable gains from other land sales.

[46] For more on this, see the "Amendment to the bright-line test for main homes" section of this Commentary.
[47] For more on this, see the "Rollover relief" section of this Commentary.

New settings that would only apply to the new build bright-line test

Apportionment where land contains a "new build" and an "old build"

Proposed new section CB 6A(1) would provide that an amount from disposing of residential land is income **to the extent** to which, using a land area test, it is for "10-year test land" or "5-year test land".

10-year test land is residential land to the extent to which it is not new build land and was acquired on or after 27 March 2021 and disposed of within 10 years of acquisition.

5-year test land is residential land to the extent to which it is new build land and:

- the person acquires it no later than 12 months after the land first meets the definition of "new build land"
- it is disposed of within 5 years of acquisition, and
- it is "new build land" when disposed of.

In the straightforward case of a new build being acquired and sold within 5 years, the new build bright-line test would apply to tax the entire piece of land. However, in cases where a new build and an old build are on the same legal title, "to the extent" means that:

- the portion of the land with a new build on it is subject to the 5-year new build bright-line test, and
- the portion of the land with an existing build on it is subject to the 10-year bright-line test.

The portion of land that relates to each dwelling includes the land immediately beneath the dwelling, as well as outdoor areas exclusive to the dwelling, and a reasonable proportion of shared areas.[48]

> **Example 56: New build bright-line test**
>
> Steph purchases a new build in May 2021. She sells the property in June 2027. Since she sold a new build, the 10-year bright-line test would not apply. Steph has owned the property for more than 5 years when she sells it, so she will not have to pay tax on any gain on sale under the bright-line test.

> **Example 57: Apportionment where "new build" and "old build" on same title**
>
> Amber purchases an existing dwelling (old build) situated on an 800m2 section for $1m in 2022, which she rents out. She builds a second dwelling on the site (on the same title) in 2025 (new build). Building the new build costs $400,000, and after it is constructed, she rents it out.
>
> After building the new build, Amber's property is comprised of the following areas:
>
> - the old build, which covers 200m2
> - exclusive areas attributable to the old build, which cover 200m2
> - the new build, which covers 200m2
> - exclusive areas attributable to the new build, which cover 150m2, and

[48] See the definition of "new build land" in proposed new section DH 5(5) and the discussion of this definition in the "Exemption for new build land" section of this Commentary.

- a common area (a shared driveway) of 50m2, which is available for use by occupants of both the existing dwelling and the qualifying new build.

After constructing the qualifying new build, Amber has spent a total of $1.4m on the property. She sells the property in 2028 for $3m, so makes a total gain on sale of $1.6m.

Amber's calculation under the bright-line test would be as follows:

New build

The portion of the land with the new build on it is subject to the 5-year new build bright-line test. This portion of the land is 375m2 (being the land under the dwelling, the exclusive outdoor area and a half share of the common driveway). This is 46.9% of the total 800m2 land area.

Amber disposes of the land more than 5 years after acquiring it – the property was purchased in 2022 and sold in 2028. It does not matter that the new build was only built in 2025 – the new build bright-line test would apply provided a new build is on the land when it is sold. Therefore, 46.9% of the gain would not be taxed on sale.

Old build

The proportion of the land with the old build on it is subject to the 10-year bright-line test as it is disposed of within 10 years of acquisition. The old build makes up 425m2 of the land (being the land under the dwelling, the exclusive outdoor area, and a half share of the common driveway). This is the remaining 53.1% of the land.

Therefore, Amber will be required to pay tax on the following amount of her gain on sale:

($3,000,000 - $1,400,000) x 53.1% = $849,600

At her marginal tax rate of 39% she has tax to pay of $331,344 on her $849,600 taxable gain on sale.

Acquired no later than 12 months after meeting the new build land definition

Under proposed new section CB 6A(2)(b)(i), if a person acquires land that already has a new build on it, the person must acquire the land no later than 12 months after first meeting the definition of "new build land" to qualify for the new build bright-line test. The definition of "new build land" is set out in proposed new section DH 5(7) and discussed in detail elsewhere in this Commentary.[49] Generally, the definition would be met when the new build received its CCC confirming it was added to the land. Therefore, when acquiring an existing new build, the land would have to be acquired no later than 12 months after the CCC was issued for the 5-year new build bright-line test to apply.

New builds purchased off the plans and a new build constructed on land already owned by the person would also qualify, provided these new builds have received their CCCs by the time the land is disposed of.

[49] See the "Exemption for new build land" section of this Commentary.

Example 58: Property acquired no later than 12 months after becoming a new build

Catherine purchases a new build from a developer in May 2022. The property received its CCC in April 2022. She sells the property to Peter in January 2023. The 5-year new build bright-line test would apply to the land, rather than the 10-year bright-line test, because Peter has acquired the new build no later than 12 months after it 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 to the land. 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 in December 2028, he will have sold it within 10 years of acquisition, so his gains on the land would be subject to tax under the 10-year bright-line test.

Disposed of within 5 years of acquisition

Under proposed new section CB 6A(2)(b)(ii), the land must be disposed of within 5 years of acquisition to be subject to tax under the 5-year new build bright-line test. Adding a new build to land after acquisition does not restart the bright-line period from the date of the new build being added.

Example 59: Adding a new build does not restart the bright-line period

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. The new build receives its CCC confirming it has been added to the land in June 2025. James sells the property in October 2029.

The bright-line period begins on 12 April 2023 (when title was issued to James) and not from June 2025 (when the new build receives its CCC). Therefore, James would only be taxed on the gains on sale if he sold the property by 11 April 2028 (that is, within 5 years of title for the property transferring to James). Since James sold the land outside of that period, the 5-year new build bright-line test would not apply.

Must be "new build land" when disposed of

Under proposed new section CB 6A(2)(b)(iii), the land must have a new build on it when it is sold for the 5-year new build bright-line test to apply. This means that provided you add a new build to land before you sell it, the new build bright-line would apply.

It also means that if you buy a new build, and it is destroyed or removed before you sell the land, the 5-year new build bright-line test would not apply.

Generally, under the proposed definition, "new build land" would mean residential land with a self-contained dwelling on it, provided the dwelling received a CCC on or after 27 March 2020 confirming it was added to the land.

Example 60: New build must be on land when sold for new build bright-line test to apply

Daniel acquires bare land in June 2025. A new build is added to the land and receives its CCC in December 2028, at which point the land would satisfy the definition of "new build land". Daniel sells the land in November 2031.

The 10-year bright-line test would not apply because Daniel has sold "new build land". Daniel would also 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.

Example 61: No CCC before sale

Melissa purchases bare land in April 2027. She commissions Bob the Builder Ltd to add a new build to the land. Bob the Builder Ltd does a substandard job of constructing Melissa's new build and goes into liquidation before the defects can be remedied. Melissa is not able to get a CCC for the new build and the bank forces a sale of the property in June 2034.

The 5-year new build bright-line test would not apply. The land would not satisfy the definition of "new build land" because the new build does not have a CCC when it is sold. However, the 10-year bright-line test would apply to tax any gains Melissa makes on selling the property. This is because she has sold the property within 10 years of acquiring it.

Example 62: Commercial to residential conversion

Erica purchases a commercial property in May 2022. She converts it to residential apartments and a CCC is issued for the residential apartments in June 2024. She sells the property in December 2028.

The bright-line period begins in May 2022, which is when Erica purchased the property. It does not matter that it was commercial land at that time. This is because the bright-line test applies whenever residential land is sold, and the land was residential land by the time it was disposed of.

The residential apartments would be considered "new builds", so the land would be "new build land" at the time it is sold. Therefore, the 10-year bright-line test would not apply, because Erica has sold "new build land". Erica would also not be taxed under the 5-year new build bright-line test as more than 5 years have passed since she acquired the land.

Application date

Clause 48(4) sets out the proposed application date for the 5-year new build bright-line test. The test would apply to property acquired on or after 27 March 2021. However, it would not apply to property acquired on or after 27 March as a result of an offer made by the purchaser on or before 23 March 2021, if the offer could not be revoked before 27 March 2021.

An irrevocable offer is one that cannot be withdrawn before a certain time. For example, it is common as part of the tender process to sign a tender document that states the person cannot withdraw their offer until 5 working days after the tender has closed.

In a typical sale and purchase, a property is acquired for tax purposes when there is a binding agreement between the vendor and purchaser. This includes the situation when the vendor accepts an offer with standard conditions that are still to be satisfied (such as obtaining finance or a building report). The property is acquired by the purchaser at the date the vendor accepts the offer and not on a later date when those conditions are satisfied or settlement occurs. Note that, in most cases, a different date is relevant for calculating the person's period of ownership for the bright-line rules – the bright-line period is generally counted from the date the land is transferred under the Land Transfer Act 2017.

Example 63: Which bright-line test applies?

Will submits an offer for a new build property as part of a tender process that closes on 23 March 2021. The new build received its CCC in May 2020. The tender document states that the offer cannot be withdrawn until 29 March. The vendor accepts the offer on 27 March and the sale and purchase agreement is signed.

While Will acquired the land on 27 March, the carve-out for irrevocable offers made on or before 23 March 2021 would apply. The existing 5-year bright-line test would apply, rather than the 5-year new build bright-line test.

The existing 5-year bright-line test applies for the same period as the 5-year new build bright-line test, and the two tests share the same settings, with only one key difference. This key difference is that the existing 5-year test has no time- or space-based apportionment for main homes.

Fact variation: Offer made on 27 March 2021

If the same facts applied as above, except that Will did not make his offer until 27 March 2021, then the 5-year new build bright-line test would apply instead.

AMENDMENT TO THE BRIGHT-LINE TEST FOR MAIN HOMES

Clauses 48, 49 and 61B

Summary of proposed amendments

The proposed amendments would ensure a main home is not taxed under the bright-line test while it is used as a main home.

Application date

The proposed amendment would apply to residential land acquired on or after 27 March 2021.[50] This means the proposed changes would apply to the 10-year bright-line test and the proposed 5-year new build bright-line test, but not the existing 5-year bright-line test.

Key features

The proposed changes would ensure that for both the 10-year bright-line test and the proposed 5-year new build bright-line test,[51] while the property is used as the person's main home, the following would apply:

- If a main home makes up more than half the land, the existing main home exclusion would continue to apply in accordance with current law. Any gain on sale that relates to periods the land was used as a main home would not be taxed under the 5-year new build bright-line test or the 10-year bright-line test.
- If the existing main home exclusion would not apply because the main home makes up less than half the land, an apportionment test would apply instead. Under the apportionment test, only the non-main home portion of the land would be taxed under the bright-line test.

Thus, a main home would not be taxed while it is being used as a main home.[52] A person who builds a second dwelling on the same land as their main home (for example, a granny flat) would continue to benefit from the existing main home exclusion where that second dwelling takes up less than half the land. The main home would also not be taxed where the portion of the land used as a main home is smaller than the non-main home portion.

The time apportionment rule, which applies when a property is not used as the main home for more than 12 consecutive months, would continue to apply regardless of whether the main home takes up more or less than half the land. This rule ensures that tax is paid on those periods of non-main home use – for example, while a dwelling is used as a rental property.

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[50] However, it would not apply 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.

[51] For more on this, see the "5-year new build bright-line test" section of this Commentary.

[52] 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.

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 rules would continue to apply as they currently do. That is, if the land is used predominantly as business premises, the bright-line test would not apply. On the other hand, if the business premises take up less than half the land, and the existing main home exclusion does not apply, the business premises would be taxed. However, the main home portion of the land would not be taxed under the bright-line test because of the proposed changes.

Background

The current main home exclusion from the bright-line test in section CB 16A applies where more than half the land is used for a main home. This means that a main home can fall outside the existing main home exclusion, and be subject to tax, if less than half the land is used as a main home. For example, if two rental properties were built on the same title as a main home and those rental properties took up more than half the land, the existing main home exclusion would not apply. All the gain on the sale of the property would be taxed if the land was sold within the applicable bright-line period, not 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. It is proposed that the amendments to how main homes are treated would also apply for the purposes of the 5-year new build bright-line test, to ensure only one set of rules apply going forward.

Detailed analysis

Quantification

It is proposed to amend the quantification provision in the bright-line test to include a space-based apportionment test (this is in addition to the existing time-based apportionment test). Under section CB 6A, the amount a person derives from disposing of residential land is prima facie income. The purpose of the quantification provision is to determine the amount attributable to the use of the property as a main home and subtract that from the income on disposal of the property. The amended quantification provision in proposed new section CB 6A(8) is as follows:

$$\text{unadjusted amount} \times \frac{(\text{main home days} \times \text{main home percentage}) + \text{adjustment days}}{\text{total days}}$$

Table 4

Key terms	Meaning	Further explanation
Excluded main home[53] *(proposed new section CB 6A(14))*	Land that has been used to some extent, but not predominantly, for a dwelling that was the main home of the person (or beneficiaries of a trust in certain circumstances).	This definition substantially replicates existing section CB 16A(2). The difference is that for the definition of "excluded main home", only **some** of the land needs to have been used as a main home, rather than **more than half** of the land.
Unadjusted amount *(proposed new section CB 6A(10))*	The **full amount of income** the person derives from disposing of the land.	
Main home days *(proposed new section CB 6A(11))*	The **total number of days** in the relevant bright-line period where less than half the land has been used as an excluded main home (that is, the "predominantly" criterion in section CB 16A(2) is not satisfied), but some of the land has still been used for a main home. It also includes **days where** the property has not been used as an "excluded main home", provided the **non-main home use period does not exceed 365 consecutive days**.	There is no limit on the number of non-main home use periods that are 365 consecutive days or less.

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 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):

- The amount attributable to the part of the property used for the main home, and 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 any period of more than 365 consecutive days 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.

[53] While not directly used in the formula itself, "excluded main home" is referred to by other terms in the formula.

Example 64: Apportionment of time and space under the bright-line test

Everly purchased a property for $500,000. It was transferred to her on 28 June 2022. She sold the property on 25 August 2028 for $1 million (2,250 days of ownership). The property is made up of her main home (70% of the land, including outdoor areas) and a minor dwelling (30% of the land, including outdoor areas). She:

- lived in the main home for 400 days
- went overseas for 250 days and rented the main home out while away
- returned to live in the main home for 300 days
- went overseas for 800 days and rented the main home out
- returned from overseas and stayed in the minor dwelling for 400 days (which therefore became her main home during this period), and
- moved out and left the minor dwelling vacant for 100 days before selling.

Everly's income calculation

The formula in proposed new section CB 6A(8) is:

$$\text{unadjusted amount} \times \frac{(\text{main home days} \times \text{main home percentage}) + \text{adjustment days}}{\text{total days}}$$

Applying the formula to Everly's facts:

- **Unadjusted amount is $1 million.** This is the full amount Everly sold her property for.
- **Main home days is 500.** This is the 400 days Everly lived in the minor dwelling plus the 100 days it was vacant before she sold it (because the non-main home use is 365 days or less).
- **Main home percentage is 30%.** This is the portion of land taken up by the minor dwelling while Everly lived in it.
- **Adjustment days is 950.** This is the sum of the 400 days Everly lived in the main home, the 250 days she rented the main home out while she was away (because the non-main home use is 365 days or less), plus the remaining 300 days Everly lived in the main home after returning from her first period overseas. The 800 days Everly rented out the property while she was overseas a second time do not count as adjustment days because they exceed 365 days.
- **Total days is 2,250.** This is the total days in the bright-line period.

So, applying the formula to the facts in this example:

$$\$1{,}000{,}000 \times \frac{(500 \times 30\%) + 950}{2250} = \$488{,}889$$

The $488,889 is then subtracted from Everly's sale price to give her total income of $511,111 under section CB 6A(1) ($1,000,000 – $488,889 = $511,111).

Cost of some residential land reduced (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 gain attributable to the main home portion of land is not taxed under the bright-line test, it is necessary to reduce both the income and deduction that may be claimed.

The quantification provision in proposed new section CB 6A(8) would reduce the income from the property to the extent it was used as a main home. The proposed amendment to section DB 23C would reduce the cost base.

Section DB 23(1) provides that a person is allowed a deduction for the acquisition cost of the land and any capital improvements. The proposed changes to section DB 23C would reduce the deduction a person can claim under section DB 23 if the proposed new quantification provision in section CB 6A(8) applied.

If the income was reduced under proposed new section CB 6A(8) because there was a main home on the land, then the proposed changes to section DB 23C would ensure that the amount the person was allowed to deduct was 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 would be able to be deducted.

The proposed amendments to section DB 23C would reduce the amount a person can deduct under section DB 23 as follows:

$$\text{cost} \times \frac{(\text{main home days} \times \text{main home percentage}) + \text{adjustment days}}{\text{total days}}$$

"Main home days", "main home percentage", "adjustment days" and "total days" have the same meaning as in section CB 6A (set out above). "Cost" means the cost of the residential land.

Example 64 continued: Cost of residential land reduced

This example uses the same facts as the example above.

Everly bought her property for $500,000 and sold it for $1 million. For the formula in proposed new section DB 23C(2):

- Cost is the $500,000 Everly paid for the property.
- Main home days is 500.
- Main home percentage is 30%.
- Adjustment days is 950.
- Total days is 2,250.

Using the formula in proposed new section DB 23C(2) gives the following amount, which has to be subtracted from the amount Everly would otherwise have been able to deduct under section DB 23:

$$\$500{,}000 \times \frac{(500 \times 30\%) + 950}{2250} = \$244{,}444$$

Everly's deduction under section DB 23, after subtracting the $244,444, would therefore be $255,556 ($500,000 – $244,444 = $255,556).

Combined impact of proposed changes to sections CB 6A and DB 23C

The combined impact of proposed changes to sections CB 6A and DB 23C would ensure the net gain on sale, after carving out amounts attributable to a main home on the land, is taxed.

Example 64 continued: Combined impact of sections CB 6A, DB 23, and DB 23C

This example uses the same facts as the examples above:

- Everly's **income** under proposed new section CB 6A is $511,111.
- Everly's **deduction** for the cost of the property under section DB 23 (after applying proposed new section DB 23C) is $255,556.

Her net income from the sale would therefore be $255,555 (which is $511,111 less $255,556). Everly's income from other sources is $70,000, so she would pay income tax on her gain as follows:

- At 33% (total income between $70,001 and $180,000): $36,300, being $109,999 of Everly's gain multiplied by 33%.
- At 39% (remaining total income exceeding $180,000): $56,767, being the remainder of Everly's gain that was not taxed at 33%, multiplied by 39%.

Everly would have tax to pay of $93,067.

This example does not include any other deductions that Everly may be entitled to, for example certain interest expenses or rates and insurance.

ROLLOVER RELIEF

Clauses 48(1) and 80D

Summary of proposed amendments

The proposed amendments would extend the rollover relief already available for certain transfers or disposals of residential land under the bright-line test to provide relief for certain transfers to family trusts and to or from look-through companies and partnerships, and also for certain transfers of land subject to the 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).

An additional amendment would ensure that transfers to effect a change in co-ownership do not reset the bright-line period.

Application date

The proposed amendments would apply to disposals of "residential land" occurring on or after the date of enactment. Rollover relief would be available even if the original acquisition pre-dates the introduction of the bright-line test.

The proposed amendment to insert sections CB 6A(5B) and (5C) (to ensure that transfers to effect a change in co-ownership do not reset the bright-line period) should apply from 1 October 2015.

Key features

Rollover relief is proposed for certain transfers or disposals of residential land for the purposes of the bright-line test in section CB 6A.

Relief would be provided for some transfers to family trusts, and to or from look-through companies and partnerships. Specific relief is also proposed for transfers to trusts constituted under the Te Ture Whenua Māori Act 1993 and transfers to land trusts as part of settling claims under te Tiriti.

The proposed amendments ensure the bright-line test would not be triggered in certain situations when there is a legal transfer of residential land. This means that a transfer would either remain outside the ambit of the bright-line rules altogether, or the transfer would not create an income tax liability under the bright-line test.

Family trusts

Rollover relief is proposed to apply for transfers of residential land to family trusts, provided that:

- each transferor of the land is also a beneficiary of the trust
- at least one of the transferors of the land is also a principal settlor of the trust, and
- each beneficiary – except for the beneficiaries who are also principal settlors – has a family connection with a principal settlor, is a company controlled by a family member beneficiary or is a charity.

Different conditions would 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. Rollover relief would apply if:

- the land is subject to the Te Ture Whenua Māori Act 1993, and
- the transferors and the beneficiaries of the trust are all either:
  - members of the same iwi or hapū, or
  - the descendants of the same tipuna (living or dead).

Land transferred to a trust as part of a settlement of a claim under te Tiriti

Rollover relief would be provided for transfers of residential land to a trust as part of a settlement of a claim under te Tiriti from a post-settlement governance entity to members of the claimant group, for example, hapū, provided that:

- the land is subject to the Te Ture Whenua Māori Act 1993
- the land is transferred to a trustee of a trust who is a Māori authority, or is eligible to be a Māori authority, and
- the trustees meet the requirements of section HF 2(3)(e)(i) (that is, they are the trustees of a trust who, on behalf of Māori claimants, receive and manage 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

Rollover relief is also proposed to apply to transfers to or from LTCs and partnerships where the persons transferring the residential land to the LTC or partnership (or acquiring it from the LTC or partnership) have ownership interests in the LTC or partnership interests in the partnership in proportion to:

- their individual interests in the land, and
- their cost base relative to the total cost base in the land.

Transfers must not be above cost

In addition to the conditions outlined above, rollover relief would only be available for these specific types of transfers 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 at the date of the transfer.

Remedial amendment to the bright-line test

A proposed remedial amendment would ensure that transfers to effect a change in co-ownership do not reset the bright-line period to the extent they do not change a person's proportional or notional proportional interest in the land.

Background

The bright-line test provides that when residential land is disposed of within ten years of acquisition, the income is taxable under section CB 6A. The bright-line test was introduced as a 2-year test for residential land acquired between 1 October 2015 and 28 March 2018. A 5-year test applies for residential land acquired between 29 March 2018 and 26 March 2021, and the 10-year bright-line test applies to residential land acquired on or after 27 March 2021.

Under the current bright-line test, when residential land 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 some circumstances exist where a disposal may not be an appropriate taxing point. In such cases, it can be justified to apply rollover treatment to ignore the disposal for the purposes of the bright-line test.

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 at the date of the transfer. 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 they are inside or outside the relevant bright-line period. It also ensures the recipient is subject to the same bright-line period as the transferor. For example, if a person acquired residential land before 1 October 2015 (that is, before the bright-line test applied) and it was subsequently transferred to someone else in a transaction that qualified for rollover relief, the recipient would not be brought within the ambit of the 10-year bright-line test even if the transfer occurred on or after 27 March 2021.

Limited rollover relief is currently available under the bright-line test. However, as the test was originally introduced as a 2-year test, extensive rules providing for rollover relief were not designed. Rollover relief is currently only provided for residential land transferred under a relationship property agreement and for certain company amalgamations. However, full relief is provided for inherited residential land.

If disposal of residential land takes place within the bright-line period, the disposal is taxed based on the market value of the land at the time of disposal in the absence of any rollover relief. This is the appropriate outcome in most cases, but there may be situations where there is a disposal for legal purposes or for the Income Tax Act 2007, but no disposal of the land in economic substance. Rollover relief may be appropriate in some of these situations to prevent an adverse tax outcome that may arise when a person disposes of land but has continuous economic ownership of that land. This would be achieved by treating the recipient as having acquired the land on the date that it was acquired by the transferor and for the same cost.

Detailed analysis

The proposed amendments would provide limited extensions to the rollover relief already available under the bright-line test. Relief would be available for certain transfers to family trusts and to or from look-through companies and partnerships. Relief is also proposed for certain transfers of land subject to the Te Ture Whenua Māori Act 1993 or made as part of a settlement of a claim under te Tiriti.

Settlements on or sales to family trusts (sections FC 9B and FC 9C)

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 period even if the settlor originally acquired the land before 1 October 2015.[54]

Proposed new section FC 9B would apply when residential land is transferred to the trustees of a trust (the test trust) (as a settlement on the trust or a sale to those trustees). Proposed new section FC 9B(2) would provide rollover relief for such a transfer if all the following conditions are satisfied:

- Each transferor of the land is also a beneficiary of the trust (paragraph (a)).
- At least one of the transferors of the land is also a principal settlor of the trust, as defined in section CB 16A(7) (paragraph (b)).
- Each beneficiary who is not a principal settlor is–
  - within four degrees of blood relationship with, or married to, or in a civil union or de facto relationship with, a beneficiary who is a principal settlor (referred to here as a "family member beneficiary") (subparagraph (c)(i))
  - a company where a 50% voting interest (or 50% market value interest, if a market value circumstance exists) is owned by a family member beneficiary (subparagraph (c)(ii))
  - a trustee of another trust that has a beneficiary who is also a family member beneficiary of the test trust (subparagraph (c)(iii)), or
  - a charity (subparagraph (c)(iv)).

To qualify as a family member beneficiary, the conditions in proposed new sections FC 9B(3) and (4) would need to be met.

Proposed new section FC 9B(3)(a) provides that beneficiaries within four degrees of blood relationship with a beneficiary who is a principal settlor would qualify as a family member beneficiary. The proposed rules are intended to mirror the existing associated person rules in sections YB 4(1), (3) and (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.

Proposed new section FC 9B(3)(b) provides that the association test would include people who are married, in a civil union, or in a de facto relationship, while proposed new section FC 9B(3)(c) is intended to cover stepchildren and in-laws.

Adoption is covered in proposed new section FC 9B(4)(a) to ensure that adopted children are counted as natural children of their adoptive parents.

Proposed new section FC 9B(4)(b) mirrors existing section YB 4(4) and provides that the association test would not be met if the person cannot reasonably be expected to know both that the other person exists and that they are within four degrees of blood relationship. This

[54] The original 2-year bright-line test applied to properties acquired on or after 1 October 2015.

is designed to deal with a small minority of situations, such as when siblings are separated at a very young age and do not know of each other's existence.

Some common examples of familial relations and the degrees of blood relationship for a principal settlor are as follows (please note this list is non-exhaustive):

- One degree of blood relationship: the principal settlor’s parents and children, or spouse.
- Two degrees of blood relationship: the principal settlor’s grandchildren, grandparents, siblings, stepparents, stepchildren, and parents-in-law.
- Three degrees of blood relationship: the principal settlor’s aunts, uncles, nieces, nephews, great-grandchildren, and great-grandparents.
- Four degrees of blood relationship: the principal settlor’s cousins, great-nieces, great-nephews, and great-great-grandchildren.

Further information on how degrees of association are determined in family situations can be found in IR620.[55]

In addition, proposed new section FC 9B(5) would require the amount of consideration provided by the trustees (if any) to be less than or equal to the total cost of the residential land to the transferor at the date of the transfer. If the amount of consideration exceeds the cost of the land to the transferor, then rollover relief would not apply even if all the other requirements of proposed new section FC 9B are met.

If the requirements for rollover relief are satisfied, proposed new section FC 9B(5) would provide the recipient trustees with a deemed acquisition cost and date that mirrors the total cost of the land to the transferor and the transferor’s acquisition date.

If, after land is transferred to the trust, 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 would apply to reverse the rollover relief by deeming the trustee to have disposed of the land at market value.

The rollover relief in proposed new section FC 9B would not cover disposals **from** trustees to beneficiaries. Disposals of residential land from the trustee to a beneficiary, where the residential land is disposed of to the 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.

Example 65: Settlement on family trust

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

[55] *IR620 A guide to associated persons definitions for income tax purposes,* available at www.ird.govt.nz.

of blood relationship (being one degree of blood relationship). This means they would satisfy the requirements in proposed new section FC 9B(2) for rollover relief.

The consideration paid by the trustees to Ronald and Sunita is equal to the price they originally paid for the property, so the transfer would also satisfy the requirements in proposed new section FC 9B(5) (which requires that the consideration they received is equal to or less than their cost base).

Sunita and Ronald would not be 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. Instead, the trustees would be deemed to have an acquisition date of 9 November 2021 for the residential land and a cost base of $1 million. The trustees' bright-line period would end on 31 January 2027 on the sale of the land for $1.7m. As this is within the 10-year period for the bright-line test (9 November 2021 to 8 November 2031), the sale would be subject to income tax under the bright-line test. Ignoring other income tax deductions, the trustees would have net bright-line income of $700,000.

Example 66: Disposal to yourself as trustee of a trust

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 $450,000, of which Neo uses $400,000 to discharge his outstanding mortgage.

Current law

Neo is subject to the 2-year bright-line test for the land.[56] 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. However, the settlement on 29 October 2022 restarts the bright-line clock and the trustee of the trust would be subject to a 10-year bright-line test.

Outcome under proposed amendment

Full rollover relief would be provided and the settlement on trust on 29 October 2022 would effectively be ignored. The trustee would take on Neo's acquisition date of 3 March 2017 and Neo's acquisition cost of $500,000, even though the trustee only provided consideration of $450,000. A subsequent disposal by the trust in 2025, for example, would not be subject to tax under the bright-line test because the 2-year test applied when Neo first acquired the land.

Māori family trust proposal

Proposed new section FC 9C would provide rollover relief for transfers of residential land that is subject to the Te Ture Whenua Māori Act 1993 to trustees in certain situations. The policy intent is to recognise that land subject to the 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.

Proposed new section FC 9C provides that rollover relief would be available for a transfer of residential land to a Māori authority, or a person eligible to be a Māori authority, as the trustee of a trust if:

- the land is subject to Te Ture Whenua Māori Act 1993 (subsection (1))
- each transferor is a beneficiary of the trust (subsection (2)), and
- the transferors of the land and the beneficiaries of the trust are all either:
  - members of the same iwi or hapū, or
  - the descendants of the same tipuna (living or dead) (subsection (2)).

[56] The 2-year test applied to residential land acquired between 1 October 2015 and 28 March 2018.

Consistent with the rule in proposed new section FC 9B(5), proposed new section FC 9C(3) sets out that the amount of consideration provided by the trustees (if any) must be less than or equal to the total cost of the residential land to the transferor for rollover relief to apply.

If the requirements for rollover relief are satisfied, proposed new section FC 9C(3) would provide the recipient trustee with a deemed acquisition cost and date that mirrors the transferor's cost base in the land and acquisition date.

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 2-year and 5-year tests. However, with the extension of the test to 10 years, this could become an impediment for iwi to transact efficiently with settlement assets involving residential land.

Proposed new section FC 9D provides that rollover relief would be available for a transfer of residential land that is subject to Te Ture Whenua Māori Act 1993 and part of the settlement of a claim under te Tiriti to a trustee of a trust who:

- is a Māori authority or is eligible to be a Māori authority (subsection (1)(a)), 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 (subsection (1)(b)).

It is intended that this would provide rollover relief for the transfer of Treaty settlement residential land from the PSGE to a member of the claimant group, for example, hapū.

If the requirements for rollover relief are satisfied, it is intended that under proposed new section FC 9D(2) the receiving trust would be deemed to have acquired the residential land at the same time the PSGE received the property from the Crown and for the same acquisition cost. This would mean that if the residential land is then disposed of beyond the claimant group, the disposal would only be subject to the bright-line test if it occurs within 10 years of the first transfer from the Crown.

Consistent with the rule in proposed new section FC 9B(5) for other trusts, proposed new section FC 9D(2) sets out that the amount of consideration provided by the trustees (if any) must be less than or equal to the total cost of the residential land to the transferor at the date of the transfer for rollover relief to apply.

Look-through companies (LTCs)

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 directly are generally the same as for someone who holds residential land through an LTC. 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.

The intent is that under proposed new section FC 9E(4)(b), rollover relief should apply to a transfer to or from an LTC when the persons transferring the residential land to the LTC – or acquiring it from the LTC – are all shareholders in the LTC in proportion to:

- their individual interests in the land, either before or after the transfer, as appropriate (subparagraph (i)), and
- their cost base relative to the total cost base in the land (again, either before or after the transfer, as appropriate) (subparagraph (ii)).

Consistent with the rollover relief for trusts in proposed new section FC 9B(5), proposed new section FC 9E(2) sets out that the amount of consideration provided (if any) would need to be less than or equal to the total cost of the land to the transferor for rollover relief to apply.

If the requirements for rollover relief are satisfied, proposed new section FC 9E(2) would provide the recipient with a deemed acquisition cost and date that mirrors the total cost of the land to the transferor at the date of the transfer and the transferor's acquisition date.

Partnerships

Like LTCs, partnerships are also transparent for tax purposes. Equally, the process of transferring residential land from the partners in a partnership to the partnership constitutes a bright-line disposal and acquisition at present. Proposed new section FC 9E would provide rollover relief for partnerships.

As for transfers to or from LTCs, the intent is that under proposed new section FC 9E(4)(c), rollover relief should apply to a transfer to or from a partnership when the group of persons transferring the land to the partnership – or acquiring it from the partnership – are all partners in the partnership and their respective partnership interests are in proportion to:

- their individual interests in the land, either before or after the transfer, as appropriate (subparagraph (i)), and
- their cost base relative to the total cost base in the land (again, either before or after the transfer, as appropriate) (subparagraph (ii)).

Proposed new section FC 9E(2) also applies to partnerships and sets out that the amount of consideration provided (if any) would need to be less than or equal to the total cost of the land to the transferor for rollover relief to apply.

If the requirements for rollover relief are satisfied, proposed new section FC 9E(2) would provide the recipient with a deemed acquisition cost and date that mirrors the total cost of the land to the transferor at the date of the transfer and the transferor's acquisition date.

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 sole ownership to a form of co-ownership (or vice versa).

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.[57] As such, there is a question of whether the registration of a transfer instrument to change the form of co-ownership of a parcel of land resets the bright-line "clock", meaning the bright-line period would start again from that point.

Proposed new sections CB 6A(5B) and (5C) would clarify that 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, provided that economic ownership of the land has not changed.

As the proposed amendments are intended to clarify an ambiguity in the current drafting of section CB 6A, the proposed application date aligns with other proposed changes to section CB 6A in the Supplementary Order Paper.

[57] 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 taxtechnical.ird.govt.nz

Remedials

LOSSES CARRIED FORWARD AFTER AN OWNERSHIP CONTINUITY BREACH

Clauses 89B–89K

Summary of proposed amendment

The proposed amendment would clarify that losses incurred after an ownership continuity breach that occurred before the 2019–20 income year can be carried forward to the 2020–21 year under the business continuity test (BCT) in section IB 3.

Application date

The proposed amendment would apply from the 2020–21 income year.

Background

The BCT was introduced by the Taxation (Annual Rates for 2020–21, Feasibility Expenditure, and Remedial Matters) Act 2021. It allows companies to carry forward tax losses to future years when they have an ownership continuity breach provided there is no major change in the nature of the business activities of the company.

It was intended that tax losses incurred after an ownership continuity breach in an income year before the 2020–21 income year could be carried forward under the new BCT. However, the drafting in section IB 3(3) technically does not allow this in all the intended circumstances. The proposed amendment would clarify this.

PART-YEAR LOSSES AND THE BUSINESS CONTINUITY TEST (BCT)

Clauses 89B–89K

Summary of proposed amendment

The proposed amendment would clarify the application of the part-year loss rules to the BCT. It would ensure companies that have a major change in the nature of their business activities and fail the BCT during an income year would be able to use losses up to the day of the breach. This would be the same as under the current part-year loss rules for a breach in ownership continuity.

Application date

The proposed amendment would apply from the 2020–21 income year.

Background

The current BCT does not work well with the part-year loss rules. Where a company has a major change in its business, and therefore fails the BCT during an income year, the current rules are unclear about how part-year losses should be treated.

From a policy viewpoint, losses incurred up to the date of the BCT breach should be available for use or offset (if possible). Tax loss components incurred after the breach should be able to be carried forward (subject to any future ownership continuity breach). This is in line with the current part-year loss rules on an ownership continuity breach.

Example 67: Business continuity test and part-year losses

Wilma Widgets Limited (WWL) had a breach in ownership continuity on 1 April 2022. However, WWL maintained a similar business before and after the ownership continuity breach, and therefore, the company carried forward its tax losses under the BCT.

On 1 October 2023, however, the company made a major change in the nature of its business activities and therefore breached the BCT. This resulted in WWL being unable to carry forward its losses. As this change happened during the year, WWL should be able to offset any losses incurred up to 30 September 2023 (the day before the breach) against any net income for the same period (or to offset the losses against income of other group companies, if permitted).

WWL should also be able to carry forward any losses incurred from 1 October 2023 (the day of the breach), subject to meeting the other requirements of the part-year loss rules (such as providing part-year accounts).

FBT – POOLED ALTERNATE RATE OPTION

Clauses 114B to 114E

Summary of proposed amendments

The proposed amendments would provide employers with a new option for calculating fringe benefit tax (FBT).

Application date

The proposed amendments would apply from 1 April 2021, except for the amendments to sections RD 50(5) and RD 60(3), which would apply for the 2021–22 and later income years.

Key features

Many fringe benefits are required to be attributed to those employees receiving the benefits. This can make the calculation of an employer's FBT liability a complex exercise. Employers can choose different calculation options. They may choose to pay FBT at the flat maximum rate of 63.93% (49.25% before 1 April 2021) or to calculate their FBT liability for each individual employee using the applicable FBT rate for each dollar of "all-inclusive pay" received by the employee.

Under the proposed new pooled alternate rate option, employers would pay FBT at the rate of 63.93% only for those employees with all-inclusive pay of $129,681 or more. This would generally only be those employees earning over $180,000 in pre-tax salary or wages (or close to that threshold), assuming employees do not receive significant fringe benefits. FBT would be payable at the rate of 49.25% for all employees with all-inclusive pay under $129,681.

Employers currently using any of the single rate, full alternate rate or short form alternate rate options would be able to switch to the new pooled alternate rate option. This means that employers who used another option for the first three quarters of the 2021–22 tax year would be able to switch to the new option for the fourth quarter of the 2021–22 tax year.

Amendments to the existing provisions setting out the close company and small business options are also proposed. The proposed amendments would allow employers using those options to pay FBT at the rate of 49.25% for all employees with all-inclusive pay under $129,681. Consistent with the approach under the proposed new pooled alternate rate option, FBT would be payable at the rate of 63.93% only for employees with all-inclusive pay of $129,681 or more.

A similar amendment is also proposed to the existing provision setting out employers' options for paying FBT when they have stopped employing staff.

Background

An employer who provides a fringe benefit to an employee is liable to pay FBT. Most fringe benefits are required to be attributed to individual employees to calculate the employer's FBT liability. Attributed benefits include:

- making available a motor vehicle for an employee's private use
- employment-related loans
- the provision of certain benefits, such as subsidised transport and contributions to superannuation schemes, where each category of benefit has a taxable value of $1,000 or more per year per employee, and
- any unclassified benefit provided with a taxable value of $2,000 or more per year per employee.

Generally, all other fringe benefits (non-attributed benefits) must be pooled. FBT is calculated on the annual taxable value of these pooled benefits at the rate of 63.93% (for benefits provided to employees who are major shareholders or to persons associated with an employee who is a major shareholder) or 49.25% (for benefits provided to all other employees).

Currently, employers may use any of the following three options to calculate their FBT liability on attributed benefits:

- the single rate option
- the full alternate rate option, and
- the short form alternate rate option.

The lowest compliance cost option is the single rate option. Under the single rate option, an employer pays tax at the highest FBT rate (currently 63.93%) on all fringe benefits provided (including non-attributed benefits) without having to carry out a compliance cost intensive calculation for each employee who receives a fringe benefit. Applying tax at the highest FBT rate is a deliberate policy setting that is intended to avoid the possibility of under-taxation.

The rate of FBT for the single rate option was increased from 49.25% to 63.93% when the new top personal tax rate of 39% for income over $180,000 was introduced. However, under this tax setting, the single rate option may result in many employers having a significantly higher FBT liability for employees receiving less than $129,681 in all-inclusive pay than if the employer attributed benefits directly to the individual employees. This is an issue where employers have no, or few, employees earning income over $180,000.

The full alternate rate option is a more accurate alternative available to employers, but it requires calculations of the employer's FBT liability for each individual employee to be carried out, which may increase compliance costs. Under the full alternate rate option, attributed benefits provided in the first three quarters are initially taxed either at the second highest FBT rate of 49.25% or at the highest FBT rate of 63.93%. A "wash-up" calculation is then performed after the end of the fourth quarter to tax every dollar of attributed benefits provided to an employee during the year at the applicable FBT rate, which is based on the employee's "all-inclusive pay".

The short form alternate rate option is an easier option for employers, but like the single rate option, it may also result in over-taxation given the top FBT rate of 63.93%. Instead of carrying out calculations of the employer's FBT liability for each employee, under the short form alternate rate option attributed benefits are taxed at a flat rate of 63.93%. Non-attributed benefits are taxed at the 49.25% rate (except where they are provided to employees who are major shareholders or to their associates).

The proposed amendments would introduce a new alternate rate option (the pooled alternate rate option) for calculating FBT. It is intended to strike a better balance between accuracy and simplicity for most employers than the existing FBT payment options. Employers with no, or very few, employees earning near or above $180,000 in salary or wages would be expected to benefit the most from the new option.

Detailed analysis

Existing calculation of FBT

Existing section RD 50(2) provides that the employer's FBT liability for fringe benefits attributed to an employee is the amount of tax on all-inclusive pay less tax on cash pay. "Tax on all-inclusive pay" is defined in subsection (3)(a) as the amount determined at the rate set out in schedule 1, part C, table 1 (reproduced below) on the amount of the employee's all-inclusive pay.

Part C
Basic rates for attributed fringe benefits

Table 1

Row	Range of dollar in all-inclusive pay	Tax rate
1	$0 – $12,530	0.1173
2	$12,531 – $40,580	0.2121
3	$40,581 – $55,980	0.4286
4	$55,981 – $129,680	0.4925
5	$129,681 upwards	0.6393

How to use this table:

Find the range in the second column for each dollar in the person's all-inclusive pay under section RD 51, and apply the relevant rate for the dollar in the third column.

Schedule 1 part C table 1: replaced, on 1 April 2021, by section 17 (and see section 3 for application) of the Taxation (Income Tax Rate and Other Amendments) Act 2020 (2020 No 65).

Calculation of all-inclusive pay (section RD 51)

The calculation of an employee's all-inclusive pay is set out in existing section RD 51(2). This amount is calculated as cash pay less tax on cash pay, plus the taxable value of all fringe benefits attributed to the employee (or a person associated with the employee) in the tax year. "Cash pay" is the cash pay of the employee for the income year in which the fringe benefit is attributed that is paid to the employee by the employer or a related employer (subsection (3)(a)). This amount includes dividends and interest derived by the employee from their employer or a related employer.

FBT rates are currently based on all-inclusive pay, rather than monetary remuneration, because it is important to include the value of fringe benefits when determining an employee's FBT rate – otherwise employers might be incentivised to provide fringe benefits instead of cash remuneration to employees earning near the personal income tax brackets.[58]

[58] For this reason, the respective levels of all-inclusive pay at which a higher FBT rate applies are determined by reference to the personal income tax rates and the income brackets at which these rates apply. For example, the all-inclusive pay of an employee earning a before-tax salary of $180,000 and receiving no fringe benefits is $129,680. Hence, the all-inclusive pay of an employee earning more than $180,000 will be $129,681 or more.

Alternate rate options (section RD 59)

Existing section RD 59 sets out how the alternate rate options work. Most relevantly, subsection (2) provides that an employer may pay FBT for any, or all, of the first three quarters of a tax year at 49.25% of the taxable value of a fringe benefit.

Subsection (4) sets out the wash-up calculation for the final quarter of the tax year under the alternate rate options. Under subsection (4), the employer must calculate the total FBT payable for each employee for the tax year and subtract the amount of FBT payable for the previous three quarters of the tax year. The difference is the amount payable for the final quarter.

Proposed amendment to allow use of pooled alternate rate option (section RD 50(5))

Existing section RD 50(5) provides that an employer may choose to pay FBT at a flat rate of 63.93% on the taxable value of attributed benefits (rather than calculating the difference between tax on all-inclusive pay and tax on cash pay under section RD 50(2)).

The proposed amendment to section RD 50(5) would provide employers with a further option. Under the proposed new pooled alternate rate option, an employer would be able to choose to pay FBT at the rate of 63.93% on the total taxable value of benefits attributed to an employee whose all-inclusive pay is $129,681 or more. For all other employees, the proposed amendment would allow the employer to pay FBT at the rate of 49.25% on the taxable value of attributed benefits.

Non-attributed benefits provided to employees who are not major shareholders will continue to be pooled and taxed at the 49.25% rate. Non-attributed benefits provided to employees who are major shareholders or to their associates will also continue to be required to be pooled and taxed at the 63.93% rate.

Employers using any of the three currently available options for the first three quarters would be able to switch to the new option. An employer switching from one of the existing options to the pooled alternate rate option may be asked to provide the information necessary for calculating its FBT payable for the final quarter.

Example 68: Pooled alternate rate option

Company A employs full-time and part-time staff in a range of roles requiring different skill sets, qualifications, and levels of experience. Salaries range from $30,000 to $178,000. However, only Employee X earns $178,000 before tax, with the next highest-paid employee earning $120,000 before tax.

In the 2021–22 tax year, Company A provides fringe benefits totalling $100,000 to all its staff members in the form of subsidised transport and some low interest, employment-related loans. No individual staff member received more than $6,000 in attributed benefits, with Employee X receiving attributed benefits to the value of $5,000.

Company A has calculated its FBT liability for attributed benefits for the first three quarters of the 2021–22 tax year under section RD 59(2). This means it paid FBT at the rate of 49.25% of the taxable value of attributed benefits for those first three quarters. As fringe benefits totalling $75,000 were provided in the first three quarters, Company A has paid FBT of $36,937.50 for that period. Company A decides to use the pooled alternate rate option to calculate its FBT liability for the final quarter of 2021–22.

When preparing the FBT return for the final quarter, Company A identifies that only one employee received all-inclusive pay of $129,681 or more in the 2021–22 tax year, being Employee X. Even if the next highest-paid employee (the employee earning $120,000) received $6,000 in attributed benefits, their all-inclusive pay would only be $95,480.

FBT for Employee X

The calculation of the total tax on Employee X's cash pay is set out below.

Income tax thresholds	Applicable marginal tax rate	Income of Employee X taxed at marginal rate	Tax on cash pay
$0 to $14,000	10.5%	$14,000	$1,470
$14,001 to $48,000	17.5%	$34,000	$5,950
$48,001 to $70,000	30%	$22,000	$6,600
$70,001 to $180,000	33%	$108,000	$35,640
> $180,000	39%	$0	$0
	Total	**$178,000**	**$49,660**

Thus, the tax on Employee X's cash pay is $49,660. As Employee X received $5,000 in attributed benefits, Employee X's all-inclusive pay is $133,340 ($178,000 - $49,660 + $5,000 = $133,340). Under the pooled alternate rate option, as Employee X's all-inclusive pay is more than $129,681, Company A is required to pay FBT on the taxable value of the attributed benefits provided to Employee X at the 63.93% rate.

Therefore, Company A's FBT liability for Employee X for the 2021–22 year is $3,196.50 ($5,000 × 63.93%).

FBT for other employees

The total FBT payable for all other employees for the 2021–22 year is calculated by subtracting the taxable value of benefits attributed to Employee X from the taxable value of attributed benefits Company A provided to all its staff during 2021–22 and then applying the 49.25% rate to this amount.

The taxable value of attributed benefits Company A provided to all its staff during 2021–22 is $100,000. Employee X received $5,000 of these benefits. This means that the total FBT payable for Company A's employees (excluding Employee X) for the 2021–22 tax year is $46,787.50 (($100,000 - $5,000) × 49.25%).

Total FBT liability

Therefore, Company A's total FBT liability for all employees (including Employee X) for the 2021–22 tax year is $49,984 ($46,787.50 + $3,196.50).

As Company A has already paid $36,937.50 in FBT for the first three quarters of the 2021–22 tax year, the FBT payable for the final quarter is $13,046.50 ($49,984 - $36,937.50).

Example 69: Employer switches from single rate option to pooled alternate rate option

Company B did not employ any staff that received $129,681 or more in all-inclusive pay in the 2021–22 tax year. Company B used the single rate option to pay its FBT liability for the first three quarters of that year and wishes to switch to the pooled alternate rate option for calculating its FBT payable for the final quarter.

Company B provided $50,000 in attributed benefits to its employees during the 2021–22 tax year and no non-attributed benefits. The taxable value of the benefits that were provided in the first three quarters was $37,500. Therefore, Company B has already paid $23,973.75 in FBT for the 2021–22 tax year using the single rate option ($37,500 × 63.93%).

Since none of its employees received $129,681 or more in all-inclusive pay, Company B calculates its FBT payable for the final quarter by simply applying the 49.25% rate to the taxable value of benefits provided to its employees during the year ($50,000 × 49.25% = $24,625) and subtracting from the resulting figure the amount of FBT it has already paid for the first three quarters of the year. This gives an amount of FBT payable for the final quarter of $651.25 ($24,625 – $23,973.75).

Proposed amendments to close company and small business options (sections RD 60 and RD 61)

Existing sections RD 60 and RD 61 set out the close company and small business options for paying FBT.

Section RD 60 applies to close companies providing fringe benefits to shareholder-employees in an income year if, in the preceding income year:

- the gross amounts of tax for both PAYE income payments and employer's superannuation cash contributions withheld were no more than $1 million
- the only benefit provided was making one or two motor vehicles available to shareholder-employees for their private use, or
- the company did not employ anyone.

The small business option in section RD 61 applies to employers providing fringe benefits to employees who are not shareholder-employees in a tax year if in the preceding tax year, the gross amounts of tax for both PAYE income payments and employer's superannuation cash contributions withheld were no more than $1 million, or the employer did not employ any employees.

Instead of paying FBT quarterly, employers using the small business option pay their FBT liability on an annual (tax year) basis, while employers using the close company option pay on an income year basis. Under both these options, an employer must either calculate its FBT liability for each individual employee under section RD 50 (and calculate the amount of FBT on non-attributed benefits under section RD 53) or pay FBT on the taxable value of all fringe benefits at 63.93%.

Proposed amendments to sections RD 60(3)(b) and RD 61(3)(b) would ensure an employer using either the close company option or the small business option could choose to pay FBT at a flat rate of 63.93% only on benefits attributed to those employees receiving $129,681 or more in all-inclusive pay, with benefits provided to all other employees taxed at 49.25%. The proposed amendments would replace the words "the total pay of each employee" with "their FBT liability" in each of the sections. This would clarify that calculating the amount of FBT for each individual employee (which involves calculating each employee's all-inclusive pay) should not be required as a practical matter if the employer opts to pay FBT at the flat rates of 63.93% on attributed benefits provided to employees receiving $129,681 or more in all-inclusive pay and 49.25% on attributed benefits provided to all other employees (as provided for in proposed new section RD 50(5)).

When an employer stops employing staff (section RD 63)

Existing section RD 63 applies to an employer who stops employing staff and does not intend to replace them.[59] Subsection (2) provides that the employer must pay FBT using section RD 59 (the full alternate rate option), treating the quarter of the tax year in which the employment ended as if it were the final quarter. Essentially this means the final quarter wash-up calculation to tax all attributed benefits at the appropriate rates must be performed in the quarter in which the employment ended. However, as an alternative to full attribution,

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[59] However, the section does not apply if the employer continues to provide a fringe benefit to a former employee.

subsection (3) provides that the employer may choose to pay FBT under the single rate option.

The proposed amendment to the cross-references in section RD 63 would clarify that the full alternate rate and single rate options are not the only options available to employers that have stopped employing staff. The short form alternate rate and pooled alternate rate options would also be available, with the quarter of the tax year in which the employment ended being treated as the final quarter under these options too.