



Inland Revenue
Te Tari Taake

POLICY AND REGULATORY STEWARDSHIP

Tax policy report: Interest limitation proposal – further scope and design issues

Date:	27 April 2021	Priority:	High
Security level:	In Confidence	Report number:	IR2021/181

Action sought

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

Contact for telephone discussion (if required)

Name	Position	Telephone
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27 April 2021

Minister of Finance
Minister of Revenue

Interest limitation proposal – further scope and design issues

Executive summary

This report seeks decisions from Ministers on certain scope and design issues for the purpose of consulting on limiting interest deductions for residential property.

The key decisions covered in this report are:

- Application of the proposal to rest homes and retirement villages.
- Whether the proposed rules are to apply to income-earning use of a main home.
- Clarification as to whether the new build exemption will apply to properties purchased off the plans prior to 27 March 2021 when the code compliance certificate is issued after 27 March 2021.
- Application of the proposal to non-close companies.
- Treatment of denied interest when residential property is sold.
- Interaction of the interest limitation proposal with the residential loss ring-fencing rules.
- Application to foreign property purchased using foreign currency loans.

Early decisions on these issues will reduce complexity and increase certainty for taxpayers. The decisions sought in this report will inform the drafting of the consultation document which officials will provide to you on 19 May.

Recommended action

We recommend that you:

Rest homes and retirement villages

1. **indicate** how the interest limitation proposal should apply to rest homes and/or retirement villages:

1.1 Rest homes and retirement villages should be specifically excluded from the scope of the interest limitation proposal (*the Ministry of Housing and Urban Development's preference*); OR

Agreed/Not agreed

Agreed/Not agreed

1.2 Only rest homes should be specifically excluded from the scope of the interest limitation proposal; OR

Agreed/Not agreed

Agreed/Not agreed

- 1.3 Rest homes and retirement villages should be subject to the interest limitation proposal;

Agreed/Not agreed

Agreed/Not agreed

2. **refer** this report to the Minister of Housing and the Associate Minister of Housing (Public Housing);

Referred/Not referred

Referred/Not referred

3. if you want the interest limitation proposal to apply to retirement villages, **discuss** this with the Minister of Housing and the Associate Minister of Housing (Public Housing);

Agreed/Not agreed

Agreed/Not agreed

4. if you want the interest limitation proposal to apply to rest homes, **discuss** this with the Minister of Health and the Associate Minister of Health;

Agreed/Not agreed

Agreed/Not agreed

Income-earning use of a main home

5. **agree** to a main home exemption from the interest limitation proposal that would cover the following situations:

5.1 Owner-occupiers with flatmates;

5.2 Owner-occupiers with boarders;

5.3 Owner-occupiers providing short-stay accommodation in their main home;

5.4 Any other income-earning use of a main home (for example, a home office);

Agreed/Not agreed

Agreed/Not agreed

New builds purchased off the plans prior to 27 March

6. **indicate** which proposal regarding the application of the new build exemption to investors who purchase properties off the plans before 27 March 2021 you would like to include in the consultation document:

6.1 The new build exemption applies in respect of properties purchased off the plans before 27 March 2021 if a code compliance certificate is issued for the property on or after 27 March 2021 (*recommended*); OR

Agreed/Not agreed

Agreed/Not agreed

6.2 The new build exemption does not apply in respect of properties purchased off the plans before 27 March 2021;

Agreed/Not agreed

Agreed/Not agreed

Application to non-close companies

7. **indicate** which of the following scope options for application to companies you would like included in the consultation document (you may select more than one):

7.1 *Option A:* Close companies only;

Agreed/Not agreed

Agreed/Not agreed

7.2 *Option B:* Close companies and “residential land-rich” companies (*recommended*);

Agreed/Not agreed

Agreed/Not agreed

7.3 *Option C:* All companies;

Agreed/Not agreed

Agreed/Not agreed

8. **agree** to include in the discussion document a proposal to amend the definition of a “close company” by treating all trustees of trusts settled by the same person (or their associates) as a single trustee;

Agreed/Not agreed

Agreed/Not agreed

Treatment of denied interest when property is sold

9. **note** that Cabinet decided that officials should consult on whether interest should be deferred rather than denied permanently if the taxpayer is not a property developer but is taxed on the disposal of their property under the bright-line test or another land sale rule (CAB-21-MIN-0045 refers);

10. **note** that the discussion document will include the following broad options for the treatment of interest expense in relation to property that will be taxable when sold:

10.1 Do not ever allow a deduction for interest with respect to the property; and

10.2 Allow all of the interest related to the property to be deductible in the year of the sale if the sale is taxable (possibly subject to anti-arbitrage and the residential loss ring-fencing rules);

11. **agree** that officials consult on the option to allow a deduction for interest in excess of non-taxable gain in the case of a capital account sale;

Agreed/Not agreed

Agreed/Not agreed

Interaction with residential loss ring-fencing rules

12. **agree** that officials consult on and consider amending some of the settings of the residential loss ring-fencing rules in order to align with the exemptions under the interest limitation proposal (for example, the new build exemption);

Agreed/Not agreed

Agreed/Not agreed

Foreign property loans

13. **indicate** how the interest limitation proposal should apply to foreign currency denominated loans for foreign residential rental property:

13.1 The proposals should not apply; OR

Agreed/Not agreed

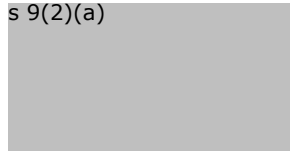
Agreed/Not agreed

13.2 The proposals should apply only to property acquired on or after 27 March 2021.

Agreed/Not agreed

Agreed/Not agreed

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Chris Gillion

Policy Lead

Inland Revenue

Hon Grant Robertson

Minister of Finance

/ /2021

Hon David Parker

Minister of Revenue

/ /2021

Purpose

1. This report sets out options for public consultation on how to treat denied interest when a property is sold. It also seeks decisions from Ministers on certain scope and design issues.
2. Where applicable, officials intend to put forward proposed approaches on the topics covered below in a consultation document and invite submissions on the details of how those approaches will be applied.

Background

3. On 8 March 2021, Cabinet agreed in principle to limit deductions for interest incurred on residential investment property (CAB-21-MIN-0045 refers). Cabinet also directed officials to consult with stakeholders on the design details of the interest limitation proposal before seeking final decisions from Cabinet.
4. Given the timeframes involved, it would be useful to get some further design decisions agreed and thereby reduce the number of issues being publicly consulted on. Refining the scope of the consultation document in this way would allow officials to concentrate their efforts on relevant second-order decisions and can help focus submissions on areas where consultation is likely to be most helpful. Early decisions on these issues will also reduce complexity and increase certainty for taxpayers.

Rest homes and retirement villages

5. This section seeks Ministerial direction on the treatment of rest homes and retirement villages. There are arguments both for and against including them in the scope of the proposed interest limitation rules and we seek your direction on how this topic should be broached in the upcoming discussion document.
6. Officials' starting position is that the definition of residential land used for the bright-line test would form the basis for property subject to the proposed interest limitation rules. At its simplest, residential land is defined as land with a dwelling on it. For the purposes of the bright-line test, a dwelling is a place that is configured as a residence or abode, whether or not it is used as such. Certain commercial structures are specifically excluded from the definition of dwelling, including hospitals, nursing homes, hospices, hotels, and motels.
7. Under the bright-line test, rest homes and retirement villages are also specifically excluded. The rationale is that these properties are not "flipped" in the same way that regular houses and apartments can be, even though in many cases they do resemble standard residential properties and are intended to be used as long-term accommodation. They are regulated and there are rules regarding who may occupy a unit. The occupant has little or no opportunity to assign rights to someone else, which minimises the risk of shorter-term speculative investment.
8. If rest homes and retirement villages were not explicitly excluded from the bright-line test, we anticipate that most residents would qualify for the main home exclusion anyway. The specific carveout therefore removes any potential uncertainty, reduces compliance costs, and provides peace of mind.
9. The relevant considerations for the proposed interest limitation rules may be slightly different. The Government's purpose for introducing the new interest limitation rule is to support more sustainable house prices and improve affordability for first home buyers by dampening investor demand for existing property.
10. Given this intention, it may be unnecessary to apply the proposed interest limitation rules to retirement villages and rest homes. While dwellings in retirement villages

may at times look physically identical to standard residential properties, demand for retirement villages is separate from demand for standard residential properties. As such, application of the interest limitation rules to retirement villages is unlikely to increase the effectiveness of the rules in supporting more sustainable house prices and improving affordability for first home buyers.

11. In addition, if retirement villages and rest homes are subject to the interest limitation rules, the operators of rest homes and retirement villages may pass the increased tax burden onto individual residents. Increasing costs for rest home and retirement village residents may be contrary to Cabinet's objective of ensuring that every New Zealander has a safe, warm, dry, and **affordable** home. While the interest limitation proposal may increase costs for renters generally, this is less justified for retirement village residents as doing so is unlikely to meet the objective of supporting more sustainable house prices and improving affordability for first home buyers.
12. If the increased costs from applying the interest limitation rules are passed on to individual residents, this could also reduce the effectiveness of the measure for supporting more sustainable house prices and improving affordability for first home buyers. Currently there may be an under-utilisation of existing housing by retirees, particularly in urban centres. This could occur because a property has been the family home for several years and the owner may be reluctant to move out even once their children have moved out. If the cost of a unit in a retirement village were to increase, this could add another barrier to downsizing. It may also increase the minimum price the owner would be willing to accept. This is an important consideration as it could impact the ability of first home buyers to enter the housing market.
13. While applying the new interest deductibility rules to retirement villages and rest homes is unlikely to directly support the Government's housing objectives, there may be other reasons why you would want to apply the new interest limitation rules to retirement villages and rest homes.
14. An exemption could be seen as providing a tax advantage to operators of retirement villages and rest homes versus providers of rental accommodation. This may be perceived as unfair, given media attention regarding the profitability and tax-paying profile of certain retirement village operators (for example, in the context of the wage subsidy).
15. If they would otherwise pass the increased tax burden onto individual residents if no specific carveout were provided, an exemption for retirement villages could also be seen as a subsidy specifically for retirees who have the financial resources to move into a retirement village. This could raise equity concerns as it disadvantages older people who do not have the financial means to move into a retirement village and must remain in private rental accommodation. This equity concern about access is not as relevant for rest homes, as the residential care subsidy is available.
16. If Ministers decide to apply the new interest limitation rules to retirement villages, you may also wish to consider treating rest homes differently from retirement villages. We consider that a distinction could be drawn between rest homes and retirement villages. Rest homes may be more akin to a nursing home, in that additional medical and assisted-living services are provided as residents are less independent than those in retirement villages more generally. Retirement villages are more like residential rental accommodation exclusively for older people (although often requiring a lump sum payment at the outset for a license to occupy, rather than ongoing rental payments).
17. Some providers will operate a combination of the two services on one site, with residents moving between a village setting and a hospital care situation more akin to a rest home as their situation dictates. Treating the two types of accommodation differently may thus lead to boundary issues or increased compliance costs.

However, we expect that these boundary issues within mixed complexes would be manageable as rest homes and retirement villages are subject to different regulatory frameworks, with rest homes requiring certification.

18. We seek your direction on whether rest homes and/or retirement villages should be outside the scope of the proposed interest limitation rules, or specifically included.
19. Te Tūāpapa Kura Kāinga – Ministry of Housing and Urban Development recommends that rest homes and retirement villages be outside the scope of the proposed interest limitation rules. This is because applying these rules to retirement villages and rest homes would not support the Government’s housing market objectives.

Income-earning use of the main home

20. We also seek your direction on whether income-earning use of a main home should be exempt from the interest limitation proposal. In the absence of such an exemption, the rules would apply to owner-occupiers who have flatmates or boarders, provide short-stay accommodation in their main home or who use their home for some other income-earning use (for example, a home office). Currently these owner-occupiers can deduct a portion of their interest for the loan used to acquire their home.
21. The Government’s press release stated that the interest deductibility rules would not affect the family home. This statement could be interpreted as saying the rules would not affect the family home as interest on the family home is generally not deductible currently (as there is no nexus with income). Alternatively, it could be interpreted as saying that any currently deductible interest on the family home will remain deductible under the new rules.
22. Not exempting main homes used for income-earning purposes could disincentivise homeowners from providing accommodation in their main home, which could place further pressure on the rental housing market. Applying the interest limitation rules to these scenarios may also have a negative effect on some first home buyers, as it is not uncommon for first home buyers to get flatmates in to help with repaying their mortgages. Providing a main home exemption would also avoid potentially worsening the existing under-utilisation of owner-occupied housing.
23. Owner-occupiers that derive rental income from having flatmates are presently required to apportion their expenses such as mortgage interest, rates and insurance between private and income-earning use based on a floor area calculation. There is tax to pay if the rental income from flatmates exceeds the total expenses attributed to income-earning use.
24. Boarders are different to flatmates. When boarders rent rooms in a house, part of the rent they pay is for services provided such as meals and laundry. A common example of a boarding situation is a home-stay student staying with a host family in their private home.
25. Officials note that not providing a main home exemption from the interest limitation proposal could be especially problematic for some owner-occupiers who have boarders.
26. An Inland Revenue determination sets out the standard cost of providing private boarding services which may be used by taxpayers instead of their actual expenses if they have four or fewer boarders. If their boarding income is equal to or less than the standard cost, the taxpayer is not required to pay tax on their boarding income.
27. If interest deductions will no longer be available to those providing private boarding services, the determination will need to be significantly revised and may need to be removed entirely, as mortgage interest is likely to make up the largest part of the

annual housing standard cost set out in the determination. This would require taxpayers to use their actual expenses (as owner-occupiers with flatmates are presently required to), thus increasing compliance costs. This would be exacerbated further by the fact that (since they would no longer be able to claim interest deductions) they would be required to pay tax on their boarding income where many of these taxpayers were not previously required to.

28. Limiting interest deductions for owner-occupiers with boarders may also affect those on low incomes. Anecdotally, Work and Income sometimes advises beneficiaries to get boarders as a means of helping to cover living costs.
29. All or part of a residential property that is a person's main home may sometimes be rented out as short-stay accommodation. While the use of a main home to provide accommodation to a flatmate or boarder would have the most beneficial impact on the housing market, the same arguments regarding supporting first home buyers to meet their mortgage repayments are also applicable other income-earning uses (such as short-stay accommodation or home offices). Exempting short-stay accommodation provided in a taxpayer's main home from the scope of the proposal would also avoid creating a boundary between flatmates and short-stay accommodation guests.
30. Officials recommend that there be a main home exemption from the interest limitation rules for all income-earning uses of a main home. The Ministry of Housing and Urban Development agrees with this recommendation.

Transitional issue with new builds purchased off the plans prior to 27 March

31. Cabinet agreed in-principle that the new build exemption would apply to property purchased in New Zealand on or after 27 March 2021, and within 12 months of receiving its code compliance certificate (CCC) (CAB-21-MIN-0045 refers). For a property purchased off the plans, the new build exemption would not apply where the property receives its CCC in (for example) January 2022 if the agreement to purchase the property was entered into before 27 March 2021. Interest deductions for the property would be phased out at a rate of 25% over four years. On the other hand, interest would be deductible if the same property was purchased on or after 27 March 2021, and within 12 months of CCC being issued.
32. Officials seek your agreement to consult on a proposal that a property purchased off the plans would qualify for the new build exemption provided the property receives its CCC on or after 27 March, even if the property is purchased before this date. This is a transitional issue that only affects new builds purchased off the plans before 27 March that receive their CCCs after this date. There are a number of reasons why officials consider this the preferred option for inclusion in the consultation document.
33. First, applying the exemption to these properties may help prevent a reduction in new housing supply. While the exemption may not necessarily be required to increase housing supply because investors will have decided to purchase these properties before 27 March, in the absence of allowing the exemption to apply some investors may decide to cancel agreements to purchase these properties where they are able to.
34. Second, it would simplify the rules by making the date an interest in these properties is first acquired irrelevant to whether the new build exemption applies. Instead, the relevant question would generally be whether a CCC for a property

purchased off the plans was issued on or after 27 March, with properties that had CCCs issued on or after 27 March within the scope of the exemption.¹

35. Third, it would reduce the need for anti-avoidance rules aimed at preventing taxpayers from entering into tax-driven arrangements to obtain the benefit of the new build exemption for properties purchased off the plans before 27 March that receive their CCCs on or after this date. For example, a taxpayer could attempt to circumvent the application date of the new build exemption by selling property to a related party on or after 27 March. Alternatively, the taxpayer could nominate a new purchaser on or after this date, because the nominee would be treated as having purchased the property when they are nominated. Such anti-avoidance rules are likely to be complex, and could be difficult for Inland Revenue to enforce.
36. Officials therefore recommend the consultation document propose that the new build exemption should apply to properties purchased off the plans that are completed and receive their CCCs on or after 27 March, regardless of when agreements to purchase such properties are entered into.

Application to non-close companies

37. In IR2021/133, T2021/847, officials considered the extent to which the interest limitation proposal should apply to companies. The report set out three scope options for companies:
 - 37.1 **Option A.** Apply it to close companies only.
 - 37.2 **Option B.** Apply it to close companies and any “residential land-rich” company where residential property makes up more than a certain percentage (say, 25 per cent) of its total assets.
 - 37.3 **Option C.** Apply it to all companies.
38. The Minister of Revenue has requested more advice on whether Option B would sufficiently limit opportunities to avoid the interest limitation rules by putting residential properties in non-close companies. Officials consider that Option B would be sufficient.

Definition of “close company”

39. A “close company” is a company where five or fewer natural persons or trustees directly or indirectly hold more than 50% of the company.² As the “close company” definition looks through interposed corporate shareholders to natural persons and trustees,³ a person cannot avoid having a “close company” by splitting the share ownership among other companies that they control.
40. The “close company” definition also treats natural persons who are associated as a single person. Relatives are treated as associated if they are within two degrees of blood relationship, or in a marriage, civil union or de facto relationship, or within two degrees of blood relationship to the person’s spouse, civil union or de facto partner. A person could not, therefore, get around the “close company” definition

¹ Note that as announced by Ministers, the exemption would also apply to properties purchased on or after 27 March and within 12 months of receiving their CCCs. This could include properties that received their CCCs before 27 March but are purchased on or after this date, and within 12 months of the CCC being issued. Officials are not asking Ministers to reconsider the eligibility of these properties for the new build exemption, because investors will have made decisions in reliance on the Government’s announcement.

² Measured by voting interest or market value.

³ Note that a “close company” is different from a “closely-held company”. The key difference is that the “close company” definition looks through interposed corporate shareholders while the “closely-held company” definition does not.

by assigning shares to their spouse, children or other close relatives. There are also other associated persons rules applying to natural persons, which can be complex.

41. Because the "close company" definition effectively looks through entities to natural persons and trustees, and treats natural person associates as a single person, it is very difficult for an individual to avoid the definition of a "close company" while maintaining control over the company. One way in which the "close company" definition could be made more robust is by treating all trustees of trusts settled by the same person (or their associates) as a single trustee. Officials recommend including this proposed change in the discussion document. With this proposed change, officials consider that even if the interest limitation proposal applied only to close companies (Option A), it should be sufficient to prevent people transferring their individually- or family-controlled properties into a debt-funded company to avoid the proposal.

Reasons for applying the rules beyond close companies

42. The reason officials recommended going further and applying the interest limitation proposal to residential land-rich companies (Option B) is that otherwise, groups of (unrelated) taxpayers may be incentivised to form widely-held companies to debt-fund residential rental investment. This may give rise to fairness issues as well as limit the impact of the proposal on house prices.
43. Officials did not recommend applying the proposal to all companies (Option C) because tracing is difficult for businesses that have many sources of funds and a variety of different assets. If businesses hold relatively small amounts of residential land, they would be able to obtain full deductibility of interest under the tracing approach anyway by ensuring all borrowing is used to fund non-residential assets. Option C could therefore impose large compliance costs for companies while raising minimal revenue (compared to Option B). This is the reason the current tax law generally does not require companies to trace interest expenses; interest is deductible to companies unless an exclusion applies. Moreover, the additional companies Option C would capture (compared to Option B) are unlikely to contribute significantly to high house prices as their core business would not involve owning residential land.
44. For the reasons above, officials recommended Option B (close companies and residential land-rich companies, with the land-rich threshold determined after consultation).

Treatment of denied interest when property is sold

45. Under the interest limitation proposal, the general treatment will be that no deduction will be allowed for interest on debt that funds investment in residential investment property. This will not apply to interest on debt that funds property development and the purchase of new builds. The discussion document will discuss details of how to implement these policies.
46. Cabinet decided that "officials consult on whether interest deductions should be denied or merely deferred if the taxpayer is not a property developer but is taxed on the disposal of their property under the bright-line test or another land sale rule" (CAB-21-MIN-0045 refers).
47. This section sets out a set of options that officials propose to include in the discussion document to discuss the deductibility of interest in situations where property will only be taxed if sold within the bright-line period and is not covered by the new build (or any other) exemption from interest limitation.

48. All of these options involve trade-offs between housing market objectives (changing housing market incentives in the interests of first home buyers) and reducing over-taxation that could result for property investors if interest is never taken into account in determining their tax liability. Option 1 has the greatest impact on the housing market, but also the most potential for overtaxing property investors. Option 3 has the least impact on the housing market (although it still shifts the market in favour of first home buyers) but more closely aligns with taxing property investors on their economic income.

Option 1: Permanent non-deductibility

49. Under the first option, interest related to residential investment property is never deductible. This would be the most effective approach in terms of tilting the playing field in favour of first home buyers, since investors would never be entitled to an interest deduction. However, it would mean that the investor is taxed on all returns from the property (including any gain on sale) with no deductions for interest.

Option 2: Deductibility if sale of property is taxable

50. If the proceeds of selling a property are fully taxed you may wish to allow a deduction for all expenses related to the property, including interest. This option is the one Cabinet requested officials consult on.

Option 2 timing of deduction

51. If this option is adopted, it would not be appropriate to allow the deduction for interest to be taken in the year when the interest is paid. Because the taxation of sale proceeds under the bright-line test is uncertain until either the property is sold or the bright-line period expires, it makes sense to:
- 51.1 deny a deduction for interest when it is paid; and
 - 51.2 then allow it only if the sale is in fact taxable.
52. Also arguing in favour of deferring interest deductions is the fact that the income from the increase in the property's value is only taxable when the property is sold – not as the property changes in value.

Option 2 loss limitation

53. If the interest expense relating to a property is greater than the gain on sale (or there is no gain), this approach would mean that the interest expense deduction either creates or increases a loss on sale. Under the current law, a loss arising on a sale of bright-line property may only be deducted against income from the sale of land. This restriction would continue to apply (consultation may include a proposal to extend it to sales taxable under the "intention of resale" test).

Option 3: Same as option 2, plus deduction for interest in excess of untaxed gain on sale

54. Officials have considered whether there is merit in allowing some interest to be deducted in capital (non-taxable) sales if there is no net under-taxation of the investment. This would be the case to the extent that interest expenses exceed the amount of untaxed gain on sale.

55. In IR2021/133, T2021/847, officials put forward this option as one to potentially include in the consultation document. This report is seeking clarification on whether Ministers are comfortable with consulting on this as an option.

Example

A residential rental property is sold for an untaxed gain of \$100, but \$150 of interest has been disallowed during the period the property was rented. The amount of interest up to the untaxed gain (\$100) would be permanently disallowed. At issue is the treatment of the \$50 of excess interest. Under options 1 and 2, this excess would also be permanently disallowed. Under option 3 it would be deductible. The principle is that the non-taxation of the \$100 gain on sale has been adequately addressed by non-deduction of the \$100 of interest, and the remaining \$50 of interest should be deductible.

56. Another way of thinking about this option is to treat it as apportioning the interest expense. Interest is first allocated to the sale of property, up to the amount of any gain on sale, and deductible to that extent only if the sale is taxable. Any remaining interest expense is allocated to the cost of renting the property out and is therefore deductible.
57. A possible objection to this approach is that it is somewhat one-sided. Interest is deductible if it exceeds a tax-free gain, but the exemption from tax for capital gains means gains are not taxable if they exceed interest. If the gain on sale in the example above were \$200, a deduction would be denied for the \$150 of interest expense, which would leave \$50 of tax-free gain which is not "countered" by non-deductible interest.

Option 3 loss limitation

58. As with option 2, if option 3 means the sale of a property results in a net loss in the year of sale (\$50 in the example above) the deductibility of this loss would be limited by current law (most likely under the residential loss ring-fencing rule, which provides that residential property expenses are generally deductible only against residential property income). This limitation would continue to apply, though modifications may be consulted on.
59. Cabinet did not consider or decide the question of whether consultation should include allowing a deduction for interest in some cases when residential investment property is sold on capital account (non-taxable). Recommendation 11 authorises officials to consult on this option for non-taxable sales.

Interaction with residential loss ring-fencing rules

60. Residential rental loss ring-fencing rules were introduced in 2018 to reduce tax benefits for property investors compared to owner-occupiers. The interest limitation proposal would shift this setting further in favour of owner-occupiers by imposing higher levels of tax on leveraged property investors. The interest limitation proposal includes some exemptions to favour new supply that were not considered for residential loss ring-fencing.
61. There will be significant interplay between the interest limitation rules and the residential loss ring-fencing rules. We think the most logical approach is to have the interest limitation rules determine if interest is potentially deductible in an income year. If it is deductible under the interest rules, the timing of the deduction may be deferred under the residential loss ring-fencing rules (if the taxpayer has

an overall residential rental loss for the year). There are likely to be many related technical issues that come up during consultation.

62. We seek guidance on whether officials may consider more significant changes to the residential loss ring-fencing rules to align with some of the exemptions being proposed for the interest limitation provisions. For example, the residential loss ring-fencing rules have no equivalent to a new build exemption. If interest is deductible under the interest limitation proposal, a portion of it could potentially be denied or deferred under the residential loss ring-fencing rules (if the interest deduction results in a net loss for the year). A way of addressing this is to say the residential loss ring-fencing rules do not apply if one of the major exemptions for interest limitation (new build and development exemptions)⁴ applies. Note that this would be liberalising the taxation of rental property investment in some cases.

Foreign property purchased using foreign currency loans

63. One area where officials have received a number of queries, and where we seek your direction, is how, if at all, these proposals might apply to foreign currency loans.
64. For the purpose of this report, we are seeking your guidance on loans denominated in a foreign currency used to fund a residential rental property that is situated outside New Zealand.⁵
65. Foreign currency loans will most commonly arise in two situations:
- 65.1 Migrants to New Zealand who hold and rent out foreign properties acquired before migrating to New Zealand; and
 - 65.2 New Zealand residents who own a foreign property as a holiday home but rent it out while they are not using it to cover part of the cost. These will be taxed under the mixed-use asset rules.
66. Some New Zealand residents may also own foreign rental properties as an investment but we expect there will be less of these than the other two situations as an equivalent investment in New Zealand rental property will be logistically easier for most New Zealanders to manage.
67. Currently, if these properties are owned by a New Zealand tax resident, expenditure on these loans will be deductible and calculated under the financial arrangements rules. This calculation will include both the New Zealand dollar equivalent of interest expenditure as well as any foreign exchange gains or losses on the principal.
68. There is more complexity in calculating interest deductions on a foreign currency loan than an equivalent New Zealand dollar loan and this would be magnified if the interest limitation proposal applies to foreign currency loans. Limiting interest deductions on foreign currency loans is likely to raise a number of issues, unintended consequences, and — depending on the method chosen — the potential for relatively large assessable income or deductions on unrealised gains and losses. Officials do not consider there is sufficient time to develop transitional proposals in time for inclusion in the discussion document to be provided to you in May, and that any transitional proposals would need to be subject to consultation due to the risks outlined above.

⁴ The residential loss ring-fencing provisions have a development exemption that applies to most developments, but it is possible the development exemption designed for the interest limitation provisions may be somewhat broader.

⁵ There are likely to be a small but unknown number of New Zealand residential rental properties financed by foreign currency loans and potentially foreign rental properties financed by New Zealand dollar loans. These are not within the scope of the guidance sought in this report.

69. One of the Government’s overarching policy objectives is to “support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first home buyers”. While not explicit, we assume this objective is to dampen investor demand for New Zealand housing stock to improve affordability for first home buyers of New Zealand houses. Limiting interest deductions on foreign properties will have no direct effect on the price of New Zealand houses.
70. Officials’ preference is to exclude foreign currency denominated loans for foreign residential rental properties from the interest limitation proposal for the following reasons:
- 70.1 This would be consistent with the intent of the interest limitation proposal to reduce investor demand for New Zealand housing.
 - 70.2 This would prevent discouraging skilled migrants that meet all relevant immigration criteria but own property in their home jurisdiction.
 - 70.3 This would reduce the complexity of the interest limitation rules and free up resources towards developing other aspects of the proposal.
 - 70.4 To the extent excluding these loans encourages investment in foreign rental properties, it may further reduce investor demand for existing New Zealand housing stock. However, due to the simpler logistics, officials consider most investors are likely to prefer a New Zealand new build over a foreign property despite similar tax treatment.
71. Alternatively, if you want to limit interest deductions for foreign currency denominated loans for foreign residential rental properties, we recommend this limitation applies only to properties acquired on or after 27 March 2021. This would more closely align the treatment of foreign loans with loans for New Zealand properties. As no transitional adjustments would be required it is only slightly more complex than a complete exclusion.

Consultation

72. The Treasury and Te Tūāpapa Kura Kāinga – Ministry of Housing and Urban Development were consulted on this report and agree with its recommendations.

Next steps

73. Officials will report to you on 19 May with a draft consultation document for your consideration.