Inland Revenue
Te Tari Taake

POLICY AND REGULATORY STEWARDSHIP

TE TAI ŌHANGA
THE TREASURY

# Tax policy report: Interest limitation on residential investment property – key policy issues

| | | | |
|---|---|---|---|
| **Date:** | 29 July 2021 | **Priority:** | Medium |
| **Security level:** | In Confidence | **Report number:** | IR2021/325<br>T2021/1935 |

## Action sought

| | Action sought | Deadline |
|---|---|---|
| Minister of Finance | **Agree** to recommendations<br>**Note** the contents of this report | 12 August 2021 |
| Minister of Revenue | **Agree** to recommendations<br>**Note** the contents of this report | 12 August 2021 |
| Minister of Housing | **Agree** to recommendations<br>**Note** the contents of this report<br>**Refer** to the Associate Minister of Housing (Public Housing) | 12 August 2021 |

## Contact for telephone discussion (if required)

| Name | Position | Telephone |
|---|---|---|
| Stephen Bond | Acting Manager, The Treasury | s 9(2)(a) |
| Chris Gillion | Policy Lead, Inland Revenue | |

29 July 2021

Minister of Finance
Minister of Revenue
Minister of Housing

# Interest limitation on residential investment property – key policy issues

## Executive summary

### Purpose

This report seeks your decisions on some important aspects of the interest limitation proposals in relation to (i) the treatment of previously denied interest deductions when a residential investment property is sold; (ii) the duration of the new build exemption; and (iii) the application of the rules to purpose-built rentals (PBR) and public housing. Early decisions on these issues are sought because they will be key to the design of the final policy, proposed for our report in late August. This report also seeks decisions on two matters that are more technical in nature ahead of the August report.

### Key policy design decisions

#### *Design of the new build exemption*

The design of the new build exemption will have the most impact on meeting your housing objectives, and will impact the other key policy design decisions.

The discussion document consulted on whether to:

- only allow interest deductions on new builds for the initial purchasers of those new builds; or
- allow interest deductions on new builds to be claimed for a fixed period starting when the code compliance certificate (CCC) is issued.

If there is a new build exemption, officials recommend that a fixed-period new build exemption for both initial and subsequent purchasers is adopted. This would support resale value for new builds, reduce economic inefficiencies, and minimise compliance and administrative costs.

The discussion document included the following options for the length of the new build exemption:

- 10 years; or
- 20 years.

A new build exemption will shift investor demand to new builds. The effect of this will be to reduce the impact that removing the deductibility of interest has on moderating house price growth. This is because the new build exemption will lead investors to value new builds closer to how they were valued prior to the tax change. A longer new build exemption would further reduce the impact that the policy has on moderating house price growth.

The new build exemption will not just affect demand for new builds. In response to leveraged investors moving into the new build market, owner-occupiers and equity investors will purchase fewer new builds and more existing homes. That means that the length of the new build exemption determines the impact that interest limitation has on the demand for, and growth in prices of, both new and existing homes. The Treasury expects relative prices between new builds and existing homes to remain unchanged over time.

Where house price inflation is less than it otherwise would have been as a result of removing interest deducibility, the supply of housing may be impacted. The degree to which supply is impacted is determined by the competitiveness of urban land markets. Where the supply of land is not flexible, a shorter new build exemption that leads to lower house price growth will have only a minor negative impact on housing supply and rents even in the medium term. Where land that can be used for housing is in abundant supply, we would expect that slower house price growth would reduce incentives to build relative to a longer exemption.

There is therefore a trade-off between a shorter new build exemption that would maximise the effect that interest limitation has on house price inflation, and, if land markets are relatively competitive, a longer exemption that would minimise any impact on housing supply. Agencies take different views on this trade-off.

**The Treasury is of the view that there should be no new build exemption, and that if there is one it should be as short as possible.** The Treasury's assessment of the evidence is that urban land markets are relatively uncompetitive. Therefore, the impact that limitation of interest deductions has on rents and housing supply in the medium term will be small, and a longer exemption for new builds will simply reduce the impact of the measure on house price inflation and undermine the Government's housing market objectives. The Treasury's analysis suggests that a 20-year new build exemption would have only a marginal, if any, impact on house price growth.

s 9(2)(f)(iv)

[redacted]

**Inland Revenue recommends a longer new build exemption to minimise impacts on supply.** While the markets for new builds and existing housing are clearly very closely related, Inland Revenue does not consider them perfect substitutes given the location, typology, and quality of new builds will often be materially different than existing houses. Inland Revenue agrees that there is likely to be some trade-off when setting the length of any new build exemption. A longer exemption is likely to mean less downward pressure on house prices. But it considers that in the long run affordability is unlikely to be promoted by measures which reduce the supply of housing and for this reason supports a longer new build exemption.

The discussion document also consulted on the idea of a "continued investment" rule, which would prevent deductions from being claimed under the new build exemption after a new build is owned by an owner-occupier. Almost all submissions were opposed to the continued investment rule and officials do not recommend it.

### *Treatment of interest deductions when a property is sold*

Whether to permanently deny interest deductions for residential property investors, or to merely defer them until a property is sold, is a key design decision. The discussion document consulted on the following options:

- Permanently denying all interest deductions subject to the interest limitation rule.
- Allowing interest deductions when a property is subject to tax on sale (for example, because it is caught by the bright-line rule).
- Allowing all interest deductions, except to the extent there is an untaxed increase in value of the property.

Permanently denying all interest deductions will maximise the impact that the policy has on reducing investor demand for housing and moderating house price growth. This is because deferral will reduce the likelihood of an investor being "over-taxed" on their investment. Officials consider however that the impact of this design decision on investor demand will be significantly smaller than your decision on the length of the new build exemption. Officials also note that, even if interest deductions are deferred rather than permanently denied, investors will be worse of compared to the status quo.

Allowing interest deductions to offset the tax paid on the gain of property sales will reduce the tax collected on those sales. Officials do not yet have an estimate of this fiscal impact, but it will be incorporated into the fiscal estimate for the final advice report in August.

Officials recommend that interest deductions be allowed to offset the tax paid by investors on the sale of their properties. When all of the income from owning a property is taxed, officials consider there is a strong fairness argument for allowing all of the deductions. Officials consider that these deductions should be limited so that they can only be used to offset tax on the gains on sale of property. This would reduce the integrity risks that could arise if taxpayers could offset deductions against their other income.

### *Purpose-built rentals*

Some submitters have proposed allowing a specific exemption for "purpose-built rentals" (PBR) from the interest limitation rules. These are properties that are owned and operated by a single entity with the intention of holding them as long-term rentals, rather than selling them in the short term for capital gains.

While PBR will be eligible for the developer exemption while they are being built, as well as the new build exemption for the length of that exemption, some submitters in the PBR industry believed there was a case for carving PBR out of the interest limitation rule altogether. Their argument was that any prospect of their interest deductions being denied in the future would reduce the likelihood of any PBR being constructed now.

s 9(2)(f)(iv)

[redacted]

***Transitional, emergency and public housing***

Most properties owned by community housing providers (CHPs) will be exempt from the interest limitation rule, due to their status as charities or because of other specific tax exemptions in the Income Tax Act. Kāinga Ora and its wholly owned subsidiaries will also be exempt from the interest limitation rules. As such, the public housing owned by Kāinga Ora will also be unaffected by the interest limitation rules.

However, public housing properties that CHPs or Kāinga Ora manage but lease from private landlords will not be exempt. In addition, public housing provided by council-controlled organisations (which, unlike councils, are subject to income tax) will also not be exempt.

HUD considers that transitional, emergency and public housing, regardless of the ownership of the property it is provided in, merits an exemption from interest limitation. Without an exemption, landlords leasing their properties to CHPs or to government for public housing will face a higher tax cost, and we would expect to see a reduction in the amount of transitional, emergency and public housing provided, or a higher cost to CHPs or the Government in procuring these places. There are currently over 24,000 applicants on the public housing register and HUD does not want to exacerbate this issue.

The Treasury and Inland Revenue recommend that you do not provide an explicit exclusion for public housing. An exemption is likely to add further complexity. All for-profit landlords should be subject to the same tax rules, whether they lease their property to a CHP, to government or to other tenants. An exemption could discourage landlords from renting directly to tenants if it is possible that a CHP or government agency would be interested in the property. If the Government wanted to mitigate the effects of the interest limitation policy on the supply of public housing it could do this directly by providing more funding to public housing. This would give it greater control over the amount of subsidy given and would ensure that for-profit landlords are taxed equally, whether the landlord leases their property to a CHP, to government or to other tenants.

### Other issues

Ministerial direction is also sought on the following matters:

- Whether the transitional rule proposed in the discussion document should be modified so that any new build receiving its CCC on or after 27 March 2020 would qualify for the new build exemption, regardless of when it was acquired.
- Whether the interest limitation rules should apply to ground lessors.

### Next steps

Officials will report to you on our final policy recommendations in late August. Once Ministers have made decisions on the final policy design, we will provide Ministers with a draft Cabinet paper and Supplementary Analysis Report on 9 September.

### Recommended action

We recommend that you:

***New build exemption***

1. **note** that Cabinet agreed in principle for officials to consult on how to exempt property purchased in New Zealand on or after the application date, and within 12 months of receiving its code compliance certificate (CCC) issued under the Building Act 2004, from the interest limitation proposal;

2. **note** that The Treasury continues to recommend that there be no new build exemption from the interest limitation rules;

3. **agree** to **<u>ONE</u>** of the following options for the application of the new build exemption:

   3.1 **In perpetuity for initial owners:** The exemption would apply for the entire time an initial owner retains their interest in the property. The exemption would not apply to a subsequent purchaser;

   Agreed/Not agreed    Agreed/Not agreed    Agreed/Not agreed

   **<u>OR</u>**

   3.2 **A fixed period for both initial owners and subsequent purchasers:** The exemption would apply for a fixed period starting on the date the property's CCC was issued *(Inland Revenue and HUD recommended option, and The Treasury's recommendation among the options consulted on)*;

   Agreed/Not agreed    Agreed/Not agreed    Agreed/Not agreed

   **<u>OR</u>**

   3.3 **In perpetuity for initial owners and a fixed period for subsequent purchasers.** The exemption would apply for the entire ownership period of initial owners and for a fixed period from the date of the CCC for subsequent purchasers;

   Agreed/Not agreed    Agreed/Not agreed    Agreed/Not agreed

4. if the new build exemption is to apply for a fixed period from the date a new build's CCC is issued for at least some owners of new builds, **agree** to **<u>ONE</u>** of the following options regarding the length of that fixed period:

    4.1 10 years *(The Treasury recommended option)*;

    Agreed/Not agreed Agreed/Not agreed Agreed/Not agreed

    **<u>OR</u>**

    4.2 20 years *(Inland Revenue and HUD recommended option)*;

    Agreed/Not agreed Agreed/Not agreed Agreed/Not agreed

***Continued investment rule for new builds***

5. **agree** that there will be no continued investment rule for new builds;

    Agreed/Not agreed Agreed/Not agreed Agreed/Not agreed

***Disposal of property subject to interest limitation***

6. **agree** to **<u>ONE</u>** of the following options:

    6.1 allow no deduction for interest in the year of sale;

    Agreed/Not agreed Agreed/Not agreed Agreed/Not agreed

    **<u>OR</u>**

    6.2 allow a deduction for interest in the year of a taxable sale only (*recommended option*); or

    Agreed/Not agreed Agreed/Not agreed Agreed/Not agreed

    **<u>OR</u>**

    6.3 allow a deduction for interest in the year of sale for all sales of residential property (including when the sale proceeds are not taxable), except to the extent that there is an untaxed gain on sale;

    Agreed/Not agreed Agreed/Not agreed Agreed/Not agreed

7. if you agree to 6.2, then **agree** that any losses from claiming interest deductions on the sale of properties can only be offset against other taxable gains from property sales (that is, extend the current anti-arbitrage rule);

    Agreed/Not agreed Agreed/Not agreed Agreed/Not agreed

***Purpose-built rentals***

8. **agree** to **<u>ONE</u>** of the following options:

    8.1 exclude purpose-built rentals (PBR) from the interest limitation rule as an asset class s 9(2)(f)(iv);

    Agreed/Not agreed Agreed/Not agreed Agreed/Not agreed

    **<u>OR</u>**

8.2 apply the general interest limitation rules to PBR s 9(2)(f)(iv) ;

Agreed/Not agreed Agreed/Not agreed Agreed/Not agreed

***Transitional, emergency and public housing***

9. **agree** to **<u>ONE</u>** of the following options:

9.1 not to explicitly exclude transitional, emergency and public housing *(The Treasury and Inland Revenue recommended option);*

Agreed/Not agreed Agreed/Not agreed Agreed/Not agreed

**<u>OR</u>**

9.2 explicitly exclude transitional, emergency and public housing *(HUD recommended option)*;

Agreed/Not agreed Agreed/Not agreed Agreed/Not agreed

***Transitional rule for new builds***

10. **agree** to modify the transitional rule for new builds so that new builds which receive their CCC on or after 27 March 2020 qualify for the new build exemption;

Agreed/Not agreed Agreed/Not agreed Agreed/Not agreed

***Ground leases***

11. **agree** that the interest limitation rules will apply to ground lessors;

Agreed/Not agreed Agreed/Not agreed

***Referral***

12. **refer** this report to the Associate Minister of Housing (Public Housing) for her information.

Referred

s 9(2)(a)

**Stephen Bond**
Acting Manager
The Treasury

**Chris Gillion**
Policy Lead
Inland Revenue

**Hon Grant Robertson**
Minister of Finance
/ /2021

**Hon David Parker**
Minister of Revenue
/ /2021

**Hon Megan Woods**
Minister of Housing
/ /2021

## Purpose

1. This report seeks your decisions on some important aspects of the interest limitation proposals in relation to (i) the treatment of previously denied interest deductions when a residential investment property is sold; (ii) the duration of the new build exemption; and (iii) the application of the rules to purpose-built rentals (PBR) and public housing. Early decisions on these issues are sought because they will be key to the design of the final policy, proposed for our report in late August. This report also seeks decisions on two matters that are more technical in nature ahead of the August report.

## Background

2. The discussion document *Design of the interest limitation rule and additional bright-line rules* was publicly released on 10 June 2021. Submissions closed on 12 July 2021 and 484 submissions were received. The majority of the submissions were from private landlords, although some were from tax advisors, property investors' representative groups, real estate agents, iwi groups, property developers and engineers.

3. The discussion document outlined that deductibility of interest expenses incurred by residential property investors will be restricted from 1 October 2021. Interest on non-new build residential investment properties acquired on or after 27 March 2021 will be denied in full. For properties purchased before 27 March 2021, interest deductions will be gradually phased out.

4. Nearly all submitters were opposed to the interest limitation proposal. Other than expressing opposition to the proposal, the main themes from submissions were as follows:

   4.1 A number of submitters considered that the proposed exclusions from the scope of the rules are not sufficient and other categories of residential property ought to be excluded. Common suggestions were explicit exclusions for all public housing and multi-unit properties where the units are all on the same title.

   4.2 The subject of new builds came up frequently in the submissions, in particular, how long the new build exemption should apply for and to whom. Most submitters wanted the exemption to apply to subsequent purchasers as well as initial owners. Several submitters requested that properties purchased as new builds before 27 March 2021 also be covered by the exemption.

   4.3 Nearly all submitters supported the proposal to use tracing as the general interest allocation approach, even though several noted that tracing can be complex and difficult.

5. Further detail on the points raised in submissions is contained in Appendix 1 to this report.

6. The key policy design decisions arising from the consultation process mainly relate to the scope of property covered by the proposed interest limitation rules, the design of the new build exemption, and disposals of property subject to interest limitation. These issues and officials' recommendations are outlined below.

## Extent of the new build exemption

7. The discussion document consulted on who should qualify for the new build exemption and how long the exemption should apply for. Options we consulted on included applying the exemption:

   7.1 in perpetuity for initial owners;

   7.2 for a fixed period from the date a new build receives its code compliance certificate (CCC) for all owners of a new build;

   7.3 in perpetuity for initial owners and for a fixed period from the date a new build receives its CCC for subsequent purchasers.

8. Most submissions received on the new build exemption concerned its length and application. Some submitters favoured an exemption that applies to all owners of a new build for a period of time, ranging from a shorter exemption (for example, 10 years) to one that applies in perpetuity. Others preferred an exemption that only applies to initial owners of a new build, with a range of views on how long it should apply for.

9. The Treasury, Inland Revenue and Te Tūāpapa Kura Kāinga – Ministry of Housing and Urban Development (HUD) recommend the exemption apply to all owners of a new build for a fixed period from the date a new build's CCC is issued, for the reasons set out in the analysis below. If you agree with the recommendation, then you will need to decide how long that fixed period should be. The options are a limited exemption (for example, 10 years) or an extensive exemption (for example, 20 years). The factors you will need to take into account are set out below.

10. The discussion document also consulted on whether there should be an additional requirement for new builds, so that a property can only qualify for the new build exemption if it has always been used as a rental property (this is referred to as the "continued investment" rule). The continued investment rule is considered after the analysis on the length and application of the exemption below.

### Analysis

11. The length of the new build exemption will have the largest impact on the Government's housing market objectives.

12. These impacts are uncertain, and depend on judgements about how competitive or uncompetitive urban land markets are and therefore how much and how quickly housing supply responds to economic signals such as price. Where the supply of land is constrained, the impact of the policy will mainly be felt as a reduction in the price of land and there will be little effect on housing supply. Where the supply of land is flexible, and therefore fixed in price, this policy may reduce incentives to build because the price of homes may fall relative to the price of land. In that case, we would expect slower house price growth to reduce incentives to build.

13. The Treasury and HUD have different views on these judgements and therefore the impacts of the different options, and how they affect the Government's housing market objectives. In summary:

   13.1 ***House prices***: The Treasury and HUD agree that a longer new build exemption would reduce the impact that interest limitation would have on moderating the rate of growth in house prices, although they take different views on the extent of this.

13.2 The Treasury's analysis suggests that a 20-year (or longer) exemption would have only a marginal, if any, impact on house price growth for either new or existing homes. HUD considers that the interest limitation rules could still have an impact on house price growth even with a 20-year (or longer) new build exemption.

13.3 ***Housing supply and rents***: The Treasury's analysis suggests that interest limitation is unlikely to be any significant impact on the supply of housing (and rents) in the medium to long term, because urban land markets are relatively uncompetitive particularly in large urban centres. Therefore, a shorter new build exemption would not significantly affect housing supply (or rents) relative to a longer exemption.

13.4 s 9(2)(f)(iv)

14. The rest of this section sets out more detailed analysis of the housing market impacts on which the agencies differ.

***The new build exemption will lead leveraged investors to prefer new builds over existing homes***

15. The new build exemption will increase the return for a leveraged investor that takes out a loan to purchase a newly built residential property, relative to the return from that investor purchasing an existing residential property. This means that a new leveraged investor will be willing to pay less for an existing property compared to an equivalent newly built property. This is consistent with Cabinet's objective to dampen investor demand for existing housing stock.

16. However, the returns from newly built residential property may still be lower than what might have been expected by leveraged investors prior to the announcement of the interest limitation policy. This is because the exemption would eventually expire under all the options currently on the table. In addition, if investors expect some moderation of house price inflation and, therefore, a lower capital gain on their investment, they may be willing to pay less now than before the change.

17. A longer new build exemption will increase the value that leveraged investors place on new builds, as they can deduct more interest related to the property, and are likely to have a larger resale market, meaning they will be more inclined to buy in the first instance. At the extreme, a perpetual new build exemption that could be passed on to subsequent investors would result in investors valuing new builds the same as before the interest limitation policy.

18. In principle, because of the higher return that they can realise on new builds, we would expect that a significant proportion of the investors currently purchasing existing homes would instead look to purchase new builds. However, some of these investors may switch to non-residential property investments instead.

19. As the change is phased in for existing owners, those that remain highly leveraged may look to sell their property and purchase a new home. These investors could either exit the residential property market entirely or invest in new builds. That shift in demand could, unchecked, lead to an increase in the price of new builds relative to existing homes. However, in response to increased leveraged investor

activity we would expect some equity investors and owner-occupiers looking to purchase property, who are unaffected by the tax changes themselves, to move to purchase existing homes rather than new build homes.

20. The new build market is probably large enough to accommodate the movement of some highly-leveraged investors into it. While there is no data on exactly how many properties are purchased or owned by highly-leveraged investors, The Treasury estimates that they purchased between 12,000 and 20,000 homes last year.[1] This is less than the 43,000 consents for new dwellings issued in the year to May 2021. It would likely take longer for highly-leveraged investors currently owning property to be accommodated in the new build market, but not all of those would necessarily seek to re-enter the residential property market.

***The impact on house prices depends on whether buyers can switch from buying new builds to buying existing houses and vice versa***

21. If new and existing homes on the market are largely substitutable, then we would expect that buyer mobility would be sufficient to ensure that the relative price of new builds compared with existing homes changes little.[2]

22. That would mean that the ultimate impact of a new build exemption will be to moderate the impact that the tax change has on overall demand and house prices across the housing market. A longer exemption would then have a smaller overall impact on the growth of house prices.

23. However, some properties will not be substitutable owing to differences in location, typology and quality of new and existing housing. There will also be transaction costs associated with selling and purchasing homes. Less substitutability between existing and new build homes would mean that, at least temporarily, a new build exemption would support the level of demand for new builds while depressing it for existing homes.

24. The Treasury's judgement is that most homes are likely to be substitutable (for example, a three bedroom home built five years ago will be substitutable for a newly built three bedroom home), or at the very least sufficient homes will be substitutable to achieve this effect. As such, The Treasury considers a longer new build exemption would lead to the interest limitation rules as a whole having only a marginal impact on prices for both new and existing properties. To the extent that homes are not substitutable, The Treasury would expect purchasers and developers would respond to the different type of demand and build homes that are substitutable, and therefore any non-substitutability effects will be transitory.

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

[1] Based on investors purchasing median-priced or below lower quartile-priced homes.
[2] This does not mean that new build properties will sell for the same price as an existing build, but that the relative price would remain the same as it is now. Under current tax settings, there is still a premium paid for new builds if they are of higher quality than the existing housing stock.

***How these price impacts affect supply depends on how competitive urban land markets are***

26. As set out above, the extent of that impact on housing supply and rents in the medium to long term is uncertain and depends on how competitive urban land markets are, and therefore how well they respond to typical economic signals.

*Table: medium-term impact of interest limitation without a new build exemption under different assumptions about competitiveness of urban land markets*

| **Urban land market** | **House prices** | **Housing supply** | **Rents** |
|---|---|---|---|
| **Competitive** | No change | ↓↓ | ↑↑ |
| **Moderately competitive** | ↓ | ↓ | ↑ |
| **Uncompetitive** | ↓↓ | No change | No change |

27. In a completely uncompetitive urban land market the changed tax rules would manifest entirely as a reduction in the price of land. Incentives to build new houses would be unaffected, as the margin between land prices and the price of a house-plus-land package would not change. Therefore, a new build exemption would have no effect on housing supply. In a totally uncompetitive land market the only effect of a new build exemption would be to reduce the impact of the rules on house prices.

28. Conversely, in a perfectly competitive urban land market, land prices are fixed. As the tax rules reduce house prices relative to (fixed) land prices, the incentive to build new houses falls. In a perfectly competitive urban land market tax deductibility has no effect on house prices (which are set by the fixed cost of land and the cost of construction). In this scenario, a new build exemption would reduce the impact of the policy on housing supply. This distinction is analogous to the effect of interest rate changes on the housing market. In a perfectly competitive land market, falling interest rates would reduce rents and leave house prices unchanged. In a perfectly uncompetitive land market, falling interest rates would boost house prices and leave rents unchanged.

29. The Treasury's assessment of the available evidence is that urban land markets are relatively uncompetitive. There is extensive economic evidence that this is the case. This includes recent experience in New Zealand, whereby falling interest rates have led to significant house price inflation and no adjustment in rents despite consistently high supply and lower demand.

30. s 9(2)(f)(iv) [redacted]

s 9(2)(f)(iv)

31. Furthermore, HUD is aware of some large developments that have been either deferred or cancelled since the announcement of the interest limitation rules. s 9(2)(b)(ii) While uncertainty over the final design of the new build exemption is a likely key reason for these developments being cancelled or deferred, they do illustrate a risk to new supply if the exemption period is too short.

32. The Treasury's assessment is that any risk to new build supply, arising from uncertainty around the exemption, is not evident in new build consents data. New build consents have continued to demonstrate strength for the two months following the announcement of the interest limitation policy. Stats NZ has reported in May 2021, 1,380 new townhouses, flats, and units were consented, the highest monthly number since records began in 1990.

***Administrative and compliance considerations***

33. If the exemption were to apply for a fixed period, whether the exemption applies for 10 or 20 years from the date a new build's CCC is issued is unlikely to make a material difference to administrative or compliance costs. Territorial authorities are required to retain records for the lifetime of a building, which is generally at least 50 years unless a house ceases to exist (for example, it is demolished following an earthquake).

34. Just applying the exemption to initial owners may minimise administrative and compliance costs, as the exemption would only apply once for each new build. However, only applying the exemption to initial owners would likely incentivise some taxpayers to enter into arrangements that ensure the legal ownership of new builds does not change, even when their ownership changes in substance (for example, by putting a house into a company and then selling the shares in the company, rather than selling the house itself). Rollover relief would also likely be required in certain circumstances (for example, when property is transferred upon the death of a taxpayer, or as part of a relationship property agreement). Rules providing rollover relief would need to be designed and then applied by both taxpayers and Inland Revenue. Tax planning issues and the need for rollover relief would be amplified with an exemption that applies in perpetuity for initial owners. However, applying the exemption to both initial owners and subsequent purchasers for a fixed period would eliminate these issues.

**Officials' recommendations on the extent of the new build exemption**

35. The Treasury recognises the need to balance the goals of moderating house prices and limiting any negative impact on housing supply and rents. The Treasury's judgement is that urban land markets are relatively uncompetitive, and so the impact on housing supply and rents from interest limitation will be relatively low in the long term. Therefore, its view is that a longer new build exemption would significantly reduce the impact that this policy has on moderating house prices, potentially close to zero, without any material positive impact on supply relative to a short exemption or no exemption.

36. Furthermore, in the absence of a comprehensive capital gains tax, interest deductibility is a means to tax more economic income from residential property investment. Therefore, on balance, The Treasury continues to recommend against

new build properties being exempt from the tax changes, but if there is an exemption recommends that Ministers adopt the shortest possible new build exemption (at most, the 10-year fixed option in the discussion document which allows owners to pass on the exemption to subsequent owners).

37. Inland Revenue recommends a longer new build exemption to minimise impacts on supply. While the market for new builds and existing housing are clearly very closely related, Inland Revenue does not consider them perfect substitutes given the location, typology, and quality of new builds will often be materially different than existing houses. Inland Revenue agrees that there is likely to be some trade-off when setting the length of any new build exemption. A longer exemption is likely to mean less downward pressure on house prices. But it considers that in the long run affordability is unlikely to be promoted by measures which reduce the supply of housing and for this reason supports a longer new build exemption.

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

## Continued investment rule for new builds

39. The discussion document consulted on whether, in addition to having to meet the definition of a "new build", a property should also have to satisfy the continued investment rule to qualify for the new build exemption. Under the continued investment rule, a property would only qualify for the exemption if it has always been used as a rental property. Any other use of a new build would permanently prevent it from qualifying for the exemption.

40. The continued investment rule could potentially encourage investment in new builds, since more new builds would cease to qualify for the exemption sooner. However, almost all submissions on the continued investment rule opposed it. The concerns were that the rule would be difficult to administer and comply with, as both Inland Revenue and taxpayers would have to find a way to keep track of how a new build property has been used, especially if a new build changes hands a number of times during the period the exemption applies for. It would likely result in litigation where new builds are acquired on the understanding that they qualify for the exemption but are later discovered to have been owner-occupied for a period by a previous owner. The rule would also result in inequitable outcomes, because two otherwise identical new builds that are rented out could have different tax treatment, depending on whether they have always been used as rentals.

41. Officials consider the difficulties associated with having a continued investment rule outweigh any potential benefits of the rule, and therefore recommend against introducing such a rule. If Ministers agree not to introduce the continued investment rule, then the use of a new build would not impact whether it qualifies for the new build exemption. Obviously, for interest to be deductible there would still have to be a nexus with income, so no interest would be deductible for periods a new build is used for private purposes (for example, if a property is used as the owner's main home or second home).

## Disposal of property subject to interest limitation

42. The discussion document canvassed some options for allowing some interest to be deducted on sale for taxable sales and non-taxable sales in accordance with Cabinet and Ministerial decisions (CAB-21-MIN-0045 amended and T2021/487, IR2021/133 refer).

43. Denying interest deductions for investors is intended to dampen demand for property from them, which could put downward pressure on prices and improve affordability for owner-occupiers, particularly first home buyers. This policy is most justified when the taxation of investors is low compared to their actual income and how they would be taxed on alternative investments. The premise of allowing the interest deduction on sale is to target the interest expense denial to cases where taxes are low relative to actual income, and also to minimise overreach cases where taxes are high relative to actual income.

44. Permanently denying all interest deductions will maximise the impact that the policy has on reducing investor demand for housing and moderating house price growth. This is because deferral will reduce the likelihood of an investor being "over-taxed" on their investment. Officials consider however that the impact of this design decision on investor demand will be significantly smaller than your decision on the length of the new build exemption. Officials also note that, even if interest deductions are deferred rather than permanently denied, investors will be worse off compared with the status quo.

### Revenue account (taxable) sales

45. The clearest case to see where it might be preferable to allow interest expense to be deducted on sale is if the sale is taxable. In this case, all of the income from owning the property has been taxed, so all deductions should be allowed. It is necessary to defer the deduction until the time of sale because with the bright-line rule, it may not be clear whether the sale is taxable until the year of sale. Deferring the interest deduction until sale also operates to offset the timing advantage that the capital gain is not taxed until sale even though the capital gain accrues over the entire holding period.

### Capital account (non-taxable) sales

46. The situation for capital account sales is more complicated, because in that case the investor is getting a benefit of a non-taxable capital gain, so it would not be right to always allow an interest deduction. However, there can still be some cases where if an interest deduction is not allowed, an investor may be overtaxed. This would be the case where the disallowed interest deduction exceeds the non-taxable capital gain. However, allowing a deduction for interest in excess of the untaxed capital gain would introduce greater complexity.

### Example

47. Suppose property is sold for a gain of $100,000 and disallowed interest was $150,000.

| Revenue account (taxable) sales | Capital account (non-taxable) sales |
|---|---|
| • Capital gain (taxed) $100,000<br>• Interest expense $150,000<br>• Interest deducted $150,000<br>Net result: net deduction of $50,000<br><br>Tax loss equals economic loss on property | • Capital gain (not taxed) $100,000<br>• Interest expense $150,000<br>• Deduction for interest in excess of untaxed capital gain $50,000<br>Net result: net deduction of $50,000<br>Tax loss equals economic loss on property |

48. If no deduction were allowed in the capital account example, the taxpayer would be taxed on more than their actual (economic) income, even though the capital gain was not taxed. This situation only arises when interest expense is greater than the gain on sale of the property, which is less likely to be the case.

**Arbitrage**

49. If interest may be deducted in the case of a revenue account sale, but not for a capital account sale, a taxpayer who wants to sell a property for a price that is less than its cost plus interest expense could benefit by treating the sale as on revenue account (taxable) instead of on capital account (not taxable). This could be done most readily by selling property subject to the bright-line rule before the expiry of the bright-line period, so it is sold on revenue account instead of capital account. This issue already exists for a taxpayer who wants to sell a property for a price that is less than its cost.

50. This benefit could be addressed by allowing the deduction (interest combined with gain/loss on sale, if the sum nets to a loss) to use only against other revenue account gains (that is, allowing losses to be deducted if the taxpayer also recognises taxable gains on other property sales). This should reduce abuse of tax-motivated property sales. A rule like this already applies for bright-line revenue account losses, and the rule could be adapted to incorporate the freed-up interest deduction.

**Officials' recommendation on the disposal of property subject to interest limitation**

51. On balance, The Treasury and Inland Revenue officials recommend that a deduction for interest be allowed in the year of sale for taxable (revenue account) sales, but not for non-taxable (capital account) sales. The reasons for this are:

    51.1 For revenue account sales, all income is taxable, so all expenses should be deductible (this is still an increase in tax on investors compared to the status quo, because currently investors can deduct interest each year as incurred).

    51.2 For capital account sales, even if we were to allow a deduction for interest in excess of non-taxable gain, it is likely to apply in relatively few cases (since very often the gain will exceed the interest expense). It would also add complexity. Interaction with the loss ring-fencing regime may prohibit the deduction for interest anyway, unless a complex amendment were to be made to that regime.[3]

[3] The rental loss ring-fencing regime restricts deductions from residential property to the extent they exceed income. If interest were deductible on sale for capital account properties, the large amount of interest

## Purpose-built rentals

52. The discussion document consulted on whether there were any specific issues regarding the purpose-built rental (PBR) sector that need to be considered in relation to the interest limitation proposals.[4] There are only a small number of PBR in New Zealand currently, and the sector is not yet widely established. Submitters and HUD's PBR reference group have raised concerns that the interest limitation rule would harm the feasibility of commercially delivered PBR in New Zealand, make it more difficult to secure finance for new developments, and stagnate the development of the sector. Almost all submissions on PBR were in favour of excluding PBR altogether as an asset class from the interest limitation rule.

53. It is unclear whether excluding PBR is necessary given the new build exemption would apply to new PBR developments. Of course, the longer the exemption applies, the less need there is to exclude them entirely. Also, while investment in new PBR would increase the number of dwellings available for rent, providing a PBR exclusion incentivises the continued use of dwellings in PBR developments as rentals instead of being sold to owner-occupiers.

54. Importantly, there are no obvious material differences between PBR and other types of residential investment property, other than perhaps the scale at which PBR are constructed. There are no existing specific regulatory frameworks for PBR in New Zealand, so the Residential Tenancies Act 1986 applies to PBR in the same way it currently applies to other residential rental properties. The similarities between PBR and other residential rental property make it likely that other investors in residential investment property will consider an exclusion for PBR to be inequitable.

### Officials' recommendations on excluding PBR from interest limitation

55. s 9(2)(f)(iv) [redacted]

56. s 9(2)(f)(iv) [redacted]

accumulated over a number of years that becomes deductible in the year of sale may exceed income for that year, resulting in a restriction on deductions.

[4] PBR is not defined in New Zealand legislation. Submitters have suggested a number of possible definitions, including requiring a development to satisfy the following criteria to qualify as a PBR:

- have a minimum number of dwellings (such as fifty dwellings);
- use the dwellings in the development as rental accommodation; and
- have a single entity that manages and owns the dwellings.

## Transitional, emergency and public housing

57. The discussion document proposed exempting Kāinga Ora and its wholly owned subsidiaries from the interest limitation rules, largely because if it were a private company rather than a Crown agency, all of its activities could be exempt from the interest limitation rules.[5] Many community housing providers (CHPs) are charities, and therefore are already exempt from income tax. Some CHPs are also exempt from income tax under section CW 42B of the Income Tax Act 2007 (ITA). The discussion document asked whether other entities should also not be subject to the interest limitation rules.

58. Some submitters expressed the view that all public housing should be excluded from the scope of the proposals, regardless of who the property owner is. In particular, they considered it unfair that Kāinga Ora is proposed to be excluded from the application of the rules but private sector landlords owning properties used for public housing are not.

59. The current income tax exemptions that apply to charities and CHPs apply on an entity basis, rather than on a property basis. However, not all property used for public housing is directly owned by the charity or CHP. The property might be leased to them by a private sector landlord. There are currently 60 registered CHPs, with 14,558 properties. The latest available data shows that over 9,000 of these properties (approximately 62 percent) are not owned by the CHPs themselves, but are leased. As such, relying on the pre-existing exemptions for charities and CHPs will not ensure most of the properties managed by CHPs are unaffected by the interest limitation rules. These 9,000 properties would be subject to interest limitation as per the discussion document (unless they are owned by a charity or other CHP).

60. Similarly, HUD and Kāinga Ora both contract a number of private properties for use for transitional, emergency and public housing. For example, of the 1,647 transitional housing places contracted by HUD since October 2019, 960 are not Crown-owned.[6]

61. Councils and council-controlled organisations (CCOs) may also provide public housing. While councils are exempt from income tax, CCOs are not. The public housing properties provided by CCOs would therefore be subject to the interest limitation rules without a specific exemption. Approximately 9,000 public housing properties are managed by councils, but we do not know how many are held by CCOs.

## Impact of interest limitation on supply of public housing

62. For properties that are owned by private landlords (not owned by Kāinga Ora, councils, charities or registered CHPs), officials consider that without an exemption the interest limitation rules are likely to have the following impacts:

    62.1 *Tilt the balance towards owner-occupiers*. This is likely to reduce the supply of public housing.

[5] In the absence of an entity-wide exemption, the urban development functions of Kāinga Ora would still be exempt from the interest limitation rules because of the development exemption. If Kāinga Ora were not a Crown agency, the public housing arm of Kāinga Ora could likely become a charity or a registered CHP, and be exempt from income tax altogether.

[6] Some of these 960 properties are owned by CHPs or charities but some are owned by private landlords.

62.2 *Maintain the existing balance with other private landlords (that is, landlords who do not lease to a public housing provider).* This is unlikely to affect the supply of public housing.

**Officials' recommendations on treatment of transitional, emergency and public housing**

63. Inland Revenue and The Treasury do not recommend a general exemption from the interest limitation rules for properties used for transitional, emergency and public housing:

63.1 An exemption is likely to add further complexity. All for-profit landlords should be subject to the same tax rules, whether they lease their property to a CHP, to government or to other tenants. An exemption could discourage landlords from renting directly to tenants if it is possible that a CHP or government agency would be interested in the property.

63.2 To the extent the rules reduce the supply of public housing, it is most likely to do so by moving properties used for public housing to owner-occupiers (where such properties are suitable for owner occupation) or to other investors less willing to lease their properties for public housing. Whether this is desirable depends on which housing objective the Government chooses to prioritise – for instance increasing public housing versus increasing owner-occupied housing.

63.3 If the Government wanted to mitigate the impacts of the interest limitation rules on the supply of public housing it could instead achieve this through providing more funding for public housing. This would provide the Government greater control over the amount of support given to public housing than an exemption from the interest limitation rules and ensure that all for-profit landlords are subject to the same tax rules.

64. HUD considers that transitional, emergency and public housing, regardless of who owns the underlying property, merits an exemption from interest limitation. Without an exemption, private landlords leasing their properties to CHPs or to government for public housing will face a higher tax cost, and HUD would expect to see a reduction in the amount of transitional, emergency and public housing provided, or a higher cost to CHPs or the Government in procuring these places. There are approximately 24,000 applicants on the public housing register, and HUD does not want to exacerbate that issue.

**Minor technical matters**

---

**Eligibility of completed new builds acquired before 27 March 2021**

65. The discussion document proposed that the new build exemption would generally only apply to properties that receive their CCCs on or after 27 March 2021 (this is referred to as the "general rule").

66. The now publicly-released Cabinet paper and minute regarding the housing tax changes (CAB-21-MIN-0045 refers), along with factsheets published at the time Ministers announced the changes in March, indicated that the Government intended for properties acquired on or after 27 March 2021 and within 12 months of CCC to qualify for the new build exemption. To give effect to this and in addition to the general rule mentioned above, the discussion document proposed a transitional rule. The transitional rule would allow properties that received their CCCs **before**

27 March 2021 to qualify for the exemption if they are acquired on or after 27 March 2021 and within 12 months of receiving their CCCs.

67. Most submissions regarding the new build exemption raised concerns with the transitional rule, with many submitters considering it inequitable that taxpayers who invested in new builds recently, but before the announcement in March, would not qualify for the exemption. The rule could result in two otherwise identical properties that received their CCCs at the same time being treated differently for tax purposes under the exemption, just because one property was acquired before 27 March 2021 and the other after this date. Members of Inland Revenue's Housing External Reference Group have indicated the rule would incentivise tax planning, with taxpayers who acquired new builds before 27 March 2021 deliberately entering into arrangements to enable those new builds to qualify for the exemption (for example, by nominating another person as the owner of the new build, or disposing of their new build to a related party, on or after 27 March 2021).

68. The transitional rule adds complexity to the new build exemption. It increases the compliance burden for taxpayers, and makes it more difficult for Inland Revenue to administer the exemption. Instead of the transitional rule, officials recommend the general rule be modified to allow any new build that receives its CCC on or after 27 March 2020 to qualify for the exemption. While this is slightly more generous than the transitional rule, modifying the general rule in this way would simplify the rules considerably, remove the unintended outcomes that could arise with the transitional rule, and eliminate the need for additional rules to prevent tax planning.

## Ground leases and long-term leases

69. A ground lease is a long-term lease of land, which may be either bare land or it may contain an existing building, that permits (and often requires) the lessee to construct a new building on the land. The rent payable (ground rent) is for the land, excluding any buildings. During the term of the lease, the lessee owns any buildings on the land, which could be new or existing. At the end of the lease, ownership of these buildings reverts to the lessor. The duration of ground leases varies, but terms of 99 or more years (even 150 years) are common.

### *Should the interest limitation rules apply to ground lessors?*

70. In a residential land context, a ground lease permits the lessee to construct (or convert) a building and subdivide it into principal units (apartments) and accompanying accessory units (for example, carparks). Anecdotally, officials understand that up to 15–20 percent of residential apartments in central Auckland might involve this ground lease/unit title structure.

71. Under the proposals in the discussion document, a ground lease of land that has a residential property on it[7] would be "residential land" and subject to the interest limitation rules. If the ground lessor has borrowed money to fund the acquisition or holding of the land, the ground lessor's interest expenditure will be denied.

72. The arguments that the interest limitation rules should not apply to ground lessors of residential land are:

[7] Or the owner has an arrangement to build a residential property, or it is bare land that could be used for constructing a residential property under the relevant district plan.

72.1 Including ground leases in the interest limitation rules may limit the ground lessor's ability to sell the land. The negative impact on the ability to sell may be particularly acute where ground leases are for very long terms.

72.2 Limiting interest deductions for ground lessors is unlikely to dampen investor demand for residential leasehold interests (for example, apartments) or make these more affordable. This is because ground lessors do not own the residential leasehold interests, which are bought and sold in the residential property market.

73. Officials do not support an exclusion for ground lessors on any of these bases. An exclusion or partial exclusion for long-term ground leases would raise complex issues and concerns around fairness for other owners of residential land. Accordingly, officials consider that the simplest approach is for the interest limitation rules to apply to all owners of residential land.

74. If the interest limitation rules are to apply to ground lessors, officials consider the developer exemption and the new build exemption should be available to ground lessors even if the ground lessor is not directly involved in the development or construction process. In the ground lease context, development and new build activity would generally be undertaken by the lessee and not by the lessor, but since the lessor will need to consent to these activities, the developer and new build exemptions should apply to both the ground lessor and to the lessee.

75. Note that separate consideration needs to be given to the use of ground leases by Māori authorities or entities eligible to be Māori authorities. This issue will be dealt with in the August report.

## Fiscal implications

76. Officials are currently working on an estimate of the fiscal implications of the proposed changes. The impacts will be provided with the final Cabinet paper. Nonetheless, the decisions could have large fiscal consequences during the forecast period.

77. The design choices that Cabinet makes will influence the fiscal impacts of the proposals. In particular, the longer the new build exemption, the less revenue that will likely be collected as a result of the decision to limit interest deductibility (CAB-21-MIN-0045 refers).

78. The option to defer or deny interest deductions on the sale of a property will also have a fiscal impact. Choosing to defer, rather than deny, interest deductions would further reduce the revenue that would otherwise be raised. The impact of this decision is likely to be smaller than the impact of the length of the new build exemption.

79. The other options in this report are likely to have more minor fiscal impacts.

## Next steps

80. Officials will report to you on our final policy recommendations in late August. Once Ministers have made decisions on the final policy design, we will provide Ministers with a draft Cabinet paper and Supplementary Analysis Report on 2 September. The relevant dates for Cabinet approval of the policy and the release of the Supplementary Order Paper (SOP) to the August bill are as follows:

| | |
|---|---|
| Report to Ministers on final policy recommendations | Late August |
| Lodgement of the Cabinet paper with the Cabinet Office | 16 September |
| Consideration at DEV Committee | 22 September |
| SOP to Ministers | 23 September |
| Cabinet approval of policy and delegation to release SOP | 27 September |
| Public release of policy decisions and SOP | 28 September |
| Finance and Expenditure Committee calls for submissions on the SOP | 29 September |
| Submissions on the SOP close | 10 November |

## Appendix – Summary of submissions on the discussion document

1. The discussion document *Design of the interest limitation rule and additional bright-line rules* was publicly released on 10 June 2021. Submissions closed on 12 July 2021 and 484 submissions were received. The majority of the submissions were from private landlords, although some were from tax advisors, property investors' representative groups, real estate agents, iwi groups, property developers and engineers.

2. The following summary outlines the main submission points that were made on all the discussion document chapters, not just those specific issues on which decisions are sought from Ministers in this report. Officials will make final policy recommendations in relation to submissions received on other aspects of the proposals in the August report.

### Overview

3. Almost all submitters were opposed to the interest limitation proposal. As an alternative to denying or deferring interest deductions, some submitters suggested capping the amount of interest expense that can be deducted (for example, at 50 percent of interest expense). Several submitters requested an exclusion for small taxpayers with rental income below a certain threshold (for example, $25,000 per year) if the proposal is to proceed.

4. Several submitters commented on the proposed 1 October 2021 application date. Some were concerned that the changes would take effect in the middle of the 2021–22 tax year and stated that application of the new rules should coincide with the start of a tax year to make the transition of pre-27 March properties into the regime less complicated for taxpayers. Several submitters requested that application of the new rules be deferred to the start of the 2022–23 income year for this reason, and also to enable all taxpayers and advisors to fully understand their obligations and the implications for them.

5. One submitter noted the possibility that the details of the rules may change during the Select Committee process and the potential for drafting errors given the short timeframe. It was considered that it would be better for the rules to have a prospective application date to provide certainty and the best chance of getting the legislation right before taxpayers have to apply it. As an alternative option it was suggested that the application date be split, so that for property acquired before 27 March 2021 the rules would apply from 1 April 2022 instead of 1 October 2021.

### Residential property subject to interest limitation

6. Submissions received on the scope of property affected by interest limitation mainly focussed on a few topics: student accommodation, properties with multiple dwellings on one title, buildings used for both commercial and residential purposes (dual purpose buildings), short-stay accommodation, and the proposal to exclude papakāinga housing from interest limitation.

7. Almost all submitters who discussed the proposal to exclude student accommodation as defined in the Residential Tenancies Act 2010 (which mostly covers halls of residence) were in favour. However, many submitters also suggested private student accommodation should be exempt as well. Various proposals to achieve this were suggested, mostly based on proximity to universities. One submitter opposed an exclusion for student accommodation as

opening loopholes incentivising conversion of regular rental properties to student accommodation to escape interest limitation.

8. Although it was not covered by the discussion document, many submitters recommended that properties with multiple dwellings on a single title should be excluded from interest limitation, as they are not likely to be purchased by owner-occupiers. This issue crosses over with the issue of purpose-built rentals (PBR), and is discussed in more detail below under the *Purpose-built rentals* heading.

9. The discussion document called for submissions on whether the all-or-nothing approach used in the bright-line test for dual purpose buildings would be appropriate in the context of interest limitation, or whether an apportionment approach would better reflect the purpose of interest limitation. All submitters who commented on this issue were in favour of an apportionment approach. Submitters suggested a variety of apportionment methods, including approaches based on floor area, rental return, or GST apportionment.

10. Submitters who commented on whether short-stay accommodation should be subject to interest limitation generally favoured a partial exception to allow for a sense of commercial purpose. Most were in favour of an exclusion, but many suggested the exclusion should only apply if the owner is GST-registered. Others suggested other limiting factors, such as a test based on turnover or the number of nights in a year that the property was used for short-stay accommodation. These factors are largely intended to separate short-stay accommodation on a commercial scale (which submitters generally thought should be excluded) from short-stay accommodation too small to reflect a commercial purpose (which submitters generally felt should be subject to interest limitation).

11. Submitters who responded to the proposal to exempt Māori communal housing, such as papakāinga housing, were mostly in favour. Some suggested further exemptions for Māori land and general title land that is residential property owned by a Māori authority. A few submitters were opposed to the proposal on the grounds that it differentiates between Māori and other ethnic groups.

**Purpose-built rentals**

12. Nearly all submitters on PBR were in favour of excluding them altogether from the interest limitation rules, because:

    12.1 New PBR developments would increase new housing supply so should be encouraged.

    12.2 These properties are not on the market for first home buyers, so there was no need to dampen investor demand for them.

    12.3 If PBR were not excluded from the interest limitation rules, there was a risk that developers would take their investment elsewhere. Allowing interest deductions for PBR would make their treatment in New Zealand more comparable with their treatment in other countries.

    12.4 The new build exemption would not suffice for PBR, because any time limit imposed on interest deductions could impact on the establishment and growth of PBR in New Zealand.

13. Various definitions of PBR were suggested by submitters. Most generally referred to the number of dwellings that make up a PBR development (for example, requiring at least fifty self-contained dwellings); required the dwellings to be held in unified ownership and to be managed by a single entity; and required the

dwellings to be used as rentals continuously or for a specific period in order to qualify.

14. Some submitters called for the exclusion to apply to existing PBR completed before 27 March 2021, as well as to new developments.

15. If PBR was not excluded, then some submitters suggested the new build exemption would have to be sufficiently long enough to not disincentivise investment in PBR. One submitter was expressly against an exclusion for PBR, on the grounds that the new build exemption would suffice for new PBR. Another submitter suggested that similar to the transitional rule proposed for new builds more generally, a rule could apply to allow PBR completed within four years of 27 March 2021 to qualify for the new build exemption.

**Entities affected by interest limitation**

***Companies***

16. Submitters generally favoured some form of exclusion for non-close companies. A number of submitters pushed for greater exclusions for widely held or listed companies, either by carving them out of the interest limitation rules entirely or by explicitly carving them out of the definition of a "close company" (since a "close company" is defined as a company controlled by 5 or fewer natural persons, it is currently possible for some widely held or listed companies to be close companies if control is highly concentrated).

17. Submitters opposed the proposal to amend the definition of "close company" by treating all trustees of trusts settled by the same person as a single trustee. They cited the possibility of wider flow-on implications and argued that more consultation was needed.

18. Several submitters considered that close companies that are Māori authorities, or eligible to be Māori authorities, should be allowed to apply the 50 percent residential investment property-rich threshold, on the basis that Māori authorities are generally widely held, even though they may technically be "close companies" because they are held by a single trust.

19. Submitters considered that groups of companies should be able to calculate the 50 percent residential investment property-rich threshold on a 66 percent-owned group or wholly-owned group basis, instead of on an entity or tax consolidated group basis. Submissions also covered other more detailed aspects of the residential investment property-rich threshold (how it is calculated, valuations, when it is tested, etc).

***Kāinga Ora and public housing***

20. Submitters were mixed as to whether Kāinga Ora and its subsidiaries should be excluded from the rules. Submitters opposed to an exclusion were concerned about an "uneven playing field".

21. The majority of submitters wanted an exclusion for public or community housing. Some wanted an exclusion to apply on a property basis (as opposed to an entity basis), while others wanted an exemption for registered community housing providers or council-controlled organisations that provide community housing.

### *Other entities*

22. Some submitters wanted exclusions for certain types of Māori entities (for example, Māori authorities or mandated iwi organisations).

## Interest allocation

23. Nearly all submitters supported the proposal to use tracing as the general interest allocation approach, even though several noted that tracing can be complex and difficult.

24. For loans drawn down before 27 March that could not be traced, the majority of submitters preferred the "stacking" option, where loans would be stacked towards non-residential assets first, based on the current market values of those assets. A few submitters were concerned that obtaining market values could be costly for some taxpayers and argued that taxpayers should also be given the option of apportioning loans based on cost.

25. Submitters were generally supportive of the high water mark proposal. Some submitters suggested the level should be set at a higher amount such as an available, but unused borrowing limit, or an earlier higher number.

26. Submitters were supportive of the proposal for all refinancing of existing loans to maintain their deductible character. Submitters were not supportive of proposals to deny deductibility of foreign currency loans from 1 October 2021 instead of phased deductions like on New Zealand dollar loans.

## Disposal of property subject to interest limitation

27. Most submitters that commented on the treatment of interest expense when residential investment property is sold considered that interest should be fully deductible when property held on revenue account is sold (that is, the sale is taxable). Many were also of the view that at least some interest should be deductible when capital account (non-taxable) property is sold. A small number of submitters thought that there should be no deduction for deferred interest on sale in order to maximise the housing market impact.

## Development and related activities

28. Submitters were supportive of the development exemption. Submitters were also largely supportive of the proposed design of the exemption of including development from taxpayers in the business of development and taxpayers who engage in one-off development. Some submitters proposed to widen the exemption to land which is held on revenue account. Submitters had mixed views as to whether land dealers should be able to obtain the development exemption.

29. The majority of submitters agreed with the proposal in the chapter to apply the exemption to the acquisition cost and development costs (in the case of land bought with the intention of development) and, where the intention to develop was formed later, additional costs incurred for the development activity. Most submitters agreed that the development exemption should apply from when the intention to develop is formed. However, the submitters differed on how this intention would be measured.

30. There was strong support from submitters to include remediation work within the development exemption. Submitters differed as to what types of remediation

should be included. Many proposed a wide definition of remediation to encompass all work which adds to housing stock, makes a house habitable or extends the life of building. However, some submitters were supportive to limiting remediation to structural improvements (earthquake strengthening and weathertightness issues) or major remediation work. Some submitters proposed that remediation to heritage buildings should be included, especially where these buildings cannot be demolished.

**Definition of new build**

31. Submissions generally support the definition of a new build as a self-contained dwelling requiring CCC. Submitters favour the definition being tied to a clear increase to housing supply, with some expressing a need for a general statement of principle rather than strict categories. It was noted that adding a room to a dwelling should qualify for the exemption, while one-for-one replacements should not, as only the former provides an increase to housing supply. Other submitters recognised that one-for-one replacements could still increase the quality and longevity of rental stock, and it would be administratively difficult to prove the number of dwellings that previously existed on a property.

32. There was strong support for the inclusion of commercial to residential conversions in the new build exemption. The issue was raised that some conversions, namely hotels and motels, may not involve work that requires a CCC and would subsequently not qualify for the new build exemption. This is particularly concerning, as some hotels/motels are likely to be converted into long-stay accommodation due to low levels of occupation following the COVID-19 pandemic.

33. Submitters suggested that CCCs, certificates of acceptance, building consents, and sale and purchase agreements could be used to prove that a property is a new build.

34. Further detail on submissions relating to heritage buildings, uninhabitable buildings, and the use of CCCs will be provided in the final policy report.

**New build exemption from the interest limitation rules**

35. Overall, there was support for the new build exemption. General critique focussed on how the exemption could increase the price of new builds, negatively impacting owner-occupiers. There were submissions on the complexity of the rules and the difficulty mum and dad investors may have in applying them. The concern was also raised that the new build exemption may undermine the interest limitation policy.

36. Submissions on the general rule claim the 27 March 2021 date is unfair. The most common submission was to date the exemption back five years to properties that received their CCC from 2016 onwards. An alternative option mentioned was that the exemption could apply to a property for a fixed period regardless of when the property's CCC was issued. So, if a 20-year fixed period applied, a 16 year-old build would still have four years of interest deductions left.

37. The transitional rule received a large number of submissions that claim it is inequitable as it could result in two identical builds receiving different treatment. There was concern that the rule could distort taxpayer behaviour, for example a taxpayer may dispose of land to an associated entity in order to fall under the transitional rule. Most submitters want the transitional rule to apply to

all new builds that received their CCC on or after 27 March 2020 regardless of when the property was acquired.

38. Submissions were largely in favour of the exemption applying to both initial owners and subsequent purchasers. Allowing deductions to pass to a subsequent purchaser can increase the resale value, providing a greater incentive for the initial investor to purchase a new build. However, many submitters did not think the exemption should be passed on to a subsequent purchaser, either because it was unfair to advantage someone who had not invested in a "new" new build, or because it would drive up the price of new builds and therefore price owner-occupiers out of the new build market.

39. The most popular option was for a fixed period to apply to both the initial owners and subsequent purchasers of a new build. The option of an in-perpetuity exemption for initial owners was also popular. Those who favoured a shorter fixed period believe investors would be incentivised to invest in further new builds sooner. Those who wanted a longer exemption believe it will provide a stronger incentive for the initial investor to purchase a new build, and allow for greater cashflow to invest in more new builds.

40. The continued investment rule was extremely unpopular among submitters, with only one submission in favour of the rule. Having to ascertain the previous use of a property was considered impractical, complex, and could create uncertainty for subsequent purchasers.

41. Submitters were generally happy for existing apportionment principles to apply in cases of complex builds. Although some thought it should not apply at all, and the whole property should become a new build, or thought a predominance test could apply.

## New build bright-line test

42. Submitters generally accepted a five-year bright-line test for new builds, however some thought new builds should have a two-year test or no test at all, to further incentivise investment in them.

43. Views on applying the new build bright-line only to initial owners were mixed. Some submitters suggested that the new build bright-line test should apply to subsequent purchasers as well, because this might better encourage new housing supply.

44. Most submissions on the new build bright-line test supported a reasonable apportionment approach where a new dwelling is added to land with an existing dwelling on the same title. A few submitters suggested alternatives to apportionment. One suggestion was that an entire section of land with a new build on it should qualify for the new build bright-line test, regardless of whether there were existing dwellings on the same section. Another suggestion was to provide taxpayers with a choice between applying a predominant test or apportioning the gain on sale.

45. A number of out-of-scope submissions were also received regarding the bright-line tests that apply to residential property generally, particularly the extended 10-year bright-line test.

## Rollover relief

46. Submitters were supportive of the proposal to provide rollover relief for interest limitation in certain circumstances, including for transfers of property upon the

death of the owner. They were also supportive of the proposal to extend the situations in which bright-line rollover will apply. However, most submitters that commented on the rollover proposals in the discussion document considered that they did not go far enough. Many suggested that rollover (especially for the purposes of the bright-line test) should apply more generally to various transactions between associated persons. Many were also opposed to the proposal that a transfer would have to be for nil consideration in order to qualify for bright-line rollover relief. They stated that the instances where no consideration would be provided would be extremely rare.

47. Some considered the proposed conditions for rollover relief for settlements of land on family trusts were also too restrictive, especially the requirement that all the beneficiaries of the trust should be associated with a principal settlor. Some also commented that the rollover relief proposed for family trusts would be too narrow for Māori authorities and their subsidiaries. It was suggested that full relief should be provided for transfers of land to an entity that is eligible to be a Māori authority, including where such an entity is subject to the Te Ture Whenua Maori Act 1993 or is established on behalf of claimants.

48. Some submitters commented on the fact that bright-line rollover for family arrangements whereby a first home buyer is helped onto the property ladder by their parents was not addressed by the proposals in the discussion document. They considered that this ought to be addressed as a matter of priority, rather than being considered at a later date as proposed in the discussion document.

49. Several submitters were concerned that some taxpayers may have been "unintentionally" caught by the previous five-year bright-line test. They suggested that any extensions to bright-line rollover should be retrospective to 29 March 2018, being the date that the five-year bright-line test first applied from.

**Interposed entities**

50. Not many submissions discussed interposed entities. Most submitters acknowledged the rules were needed for integrity reasons but expressed concerns over the complexity of the rules.

51. A few submitters suggested interposed entities were common, but it is not clear that all those submitters understood when the proposed rules would apply. One reason given for why taxpayers may have an interposed entity (by borrowing at the shareholder level instead of at the entity level) was that banks often prefer to lend to individuals, especially if the company is new and has limited assets. In contrast, individuals may have other sources of income and assets.

52. Several submitters argued that the interposed entity rules should not apply to widely held companies at all, as taxpayers were unlikely to borrow to acquire shares in widely held residential investment property companies as a substitute for acquiring residential investment property directly. A few submitters also disagreed with the proposal that phasing would not apply to existing interests in interposed entities.

53. For the proposed apportionment rule for close companies, most submitters preferred an annual calculation frequency though some submitters preferred a quarterly calculation.

### Implications for the rental loss ring-fencing rules

54. Submitters agreed that there will be overlap between the interest limitation rules and the rental loss ring-fencing (RLR) rules. Submitters generally agreed that the interest limitation rules should apply first, then the RLR rules should follow. Submitters agreed that to obtain the full benefit of a new build exemption, the RLR rules should be amended to add a new build exemption.

55. The majority of submitters recommended that the RLR rules be repealed. They expressed the view that the rules would be redundant in combination with the interest limitation rules. They also emphasised the high compliance costs with these rules.

### Interest limitation and mixed-use property

56. Submitters noted that the mixed-use assets rules will be further complicated by the proposed interest limitation rules and a number expressed support for simplifying the rules, with some providing specific suggestions on how to do that. Submitters generally agreed that in the case of mixed-use property that is subject to the interest limitation rules, the interest limitation rules should take priority over the mixed-use assets rules. Views were mixed on whether the existing "stacking" approach under the mixed-use assets rules should apply when mixed-use property is held by a close company or whether tracing should apply to determine the deductibility of interest in such cases.

### Administration

57. Around 20 submitters commented on the administration of the proposal. Submitters were largely concerned about increased compliance costs, in particular increased time and cost for tax agents. Some submitters agreed there may be some need for taxpayers to provide additional information to Inland Revenue. Other submitters were against additional information requirements as self-assessment and existing record-keeping rules would already require taxpayers to retain relevant information.

58. Several submitters recommended that, to increase certainty, Inland Revenue should publish guidance on the records the Commissioner of Inland Revenue expects the taxpayer to retain, particularly in relation to the new build exemption.