In Confidence

Office of the Minister of Finance

Office of the Minister of Housing

Office of the Minister of Revenue

Chair, Cabinet Economic Development Committee

Taxation of Housing: Limiting Interest Deductions for Residential Property and Changes Related to the Bright-Line Extension

Proposal

1. This paper seeks the Cabinet Economic Development Committee's agreement to a package of tax reforms that would:

   1.1 limit interest deductions for investors in residential property; and

   1.2 address issues arising out of the extension of the bright-line test from five years to ten years.

2. The reforms follow Cabinet's in-principle decisions on 8 March 2021 (CAB-21-MIN-0045 refers) and the Government's public consultation on a discussion document (*Design of the interest limitation rule and additional bright-line rules*).

Relation to Government Priorities

3. The Government is committed to laying the foundations for a better future through addressing housing affordability. This includes making changes to tax settings to improve affordability for first home buyers by dampening investor demand for existing properties.

4. On 15 February 2021 (CAB-21-MIN-0018 refers), Cabinet agreed on the following policy objectives for the housing market:

   4.1 Ensure every New Zealander has a safe, warm, dry, and affordable home to call their own – whether they are renters or owners.

   4.2 Support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers.

   4.3 Create a housing and urban land market that credibly responds to population growth and changing housing preferences, that is competitive and affordable for renters and homeowners, and is well-planned and well-regulated.

5. The reforms outlined in this paper seek primarily to address the second objective above by dampening investor demand for existing housing stock, thereby creating more opportunities for first home buyers. However, the proposals have also been considered against the other two housing market objectives above.

Executive Summary

6. In March 2021, Cabinet agreed to two tax proposals that would reduce investor demand for existing housing and improve housing affordability for first home buyers (CAB-21-MIN-0045 refers). The first proposal was an extension of the bright-line test, which taxes gains from residential land sold within a specified period. Cabinet agreed to extend the bright-line period from five years to ten years, except for new builds, and the change was included in a Bill enacted on 30 March 2021.[1]

7. The second proposal was to limit investors' interest deductions relating to residential property with effect from 1 October 2021, again with an exemption for new builds. As limiting interest deductions can be complex, Cabinet agreed in-principle to the proposal and some of its key features in order to provide sufficient certainty in an announcement. Cabinet directed officials to consult on the detail of the proposal, with decisions to be confirmed following consultation. Consultation on the interest limitation proposal has now been completed.

8. This paper asks Cabinet to confirm its earlier in-principle decisions and seeks agreement on key features of the reforms. These include:

   8.1 property that should be subject to interest limitation;

   8.2 exclusions and exemptions from interest limitation;

   8.3 the design and length of the new build exemption; and

   8.4 treatment of previously limited interest deductions when a property is taxed on sale.

9. The estimated revenue gain from the interest limitation proposal is **$1.12 billion** over the forecast period. The revenue will decline from 2026 as investment is increasingly reallocated towards new builds, for which interest deductions will continue to be allowed. It should be noted that the estimate is highly uncertain due to the assumptions and projections involved. Implementation and administration of the reforms will increase the outreach, assistance, compliance and policy work expected of Inland Revenue over an extended period of time. Additional funding of $19.38 million over the forecast period is sought to help meet additional administration and implementation costs.

10. This paper also seeks Cabinet's agreement to delegate authority to:

   10.1 the Minister of Revenue, in consultation with the Leader of the House, to release a Supplementary Order Paper (SOP) containing these reforms at the Finance

1 Taxation (Annual Rates for 2020–21, Feasibility Expenditure, and Remedial Matters) Act 2021 (2021 No 8).

and Expenditure Committee stage of the Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Bill.

10.2 the Minister of Finance and Minister of Revenue to make additional joint decisions on any policy and drafting issues arising from the interest limitation proposal or additional bright-line changes in consultation with the Minister of Housing and Minister for Land Information as appropriate.

Background

11. Housing costs compared to income are high in New Zealand compared to other OECD countries.[2] Housing affordability is an important factor in determining people's wellbeing, particularly for low-income families where housing costs represent a higher proportion of total income. Nationally, house prices have been rising at a rate faster than wages over the past five years.[3] This trend has accelerated over the past year. House prices have increased 25.2% percent year-on-year to July 2021, with the median price at that time being $826,000.[4]

12. There are many different reasons for these increases. The Government views housing affordability as a priority and has a number of initiatives underway to address this. These tax reforms are part of these initiatives. The reforms tackle the issue of high house prices from the demand side, by reducing investor demand for residential property. The Government is also introducing a package of supply-side measures to address housing affordability in the long term. However, these measures will take some time to have an impact.

13. Many landlords who invest in residential property do so expecting to earn a large capital gain when they sell their property. The current tax system allows landlords to deduct all interest expenditure relating to their residential rental properties, even if they do not pay any tax on the capital gain when they sell their property. This situation will not be allowed to continue and interest deductions related to residential rental properties will be limited. To ensure there is no adverse impact on housing supply, property development and new builds will be exempt from the interest limitation rules.

14. On 10 June 2021, the Government released a discussion document on the design of the interest limitation rule and additional changes relating to the bright-line test. Over 450 submissions were received. This paper seeks to confirm the in-principle decisions previously made by Cabinet, and to get approval for other key design decisions that arose in the course of consultation.

Overview of tax proposals

15. As noted above, in March 2021 Cabinet made the in-principle decision to limit deductions for interest incurred to earn income from residential property (CAB-21-MIN-

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[2] OECD Better Life Index (2020). http://www.oecdbetterlifeindex.org/topics/housing/.

[3] Stats NZ, Housing in Aotearoa: 2020, pp 48, Figure 35. https://www.stats.govt.nz/assets/Uploads/Reports/Housing-in-Aotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf

[4] REINZ Monthly Report July, pp 3 (Released 12 August 2021).

0045 refers). In summary, the key in-principle decisions relating to the interest limitation proposal are:

15.1 the rules would apply to interest incurred on or after 1 October 2021;

15.2 for pre-existing loans relating to property acquired before 27 March 2021, interest denial would be phased at 25 percent per year over four years;

15.3 loans drawn down after 27 March 2021 would be subject to full limitation from 1 October 2021 regardless of when the property was acquired;

15.4 property developers can continue deducting interest expenses as incurred;

15.5 new build properties would be exempt from the interest limitation rules, with officials consulting on the details of this; and

15.6 officials would consult on whether deductions should be denied or merely deferred if the taxpayer is ultimately taxed on the disposal of their property.

16. In addition to the interest limitation decisions above, Cabinet agreed to extend the bright-line test from five years to ten years. The bright-line test taxes residential land that is bought and sold within the specified “bright-line” period. Cabinet noted that officials would consult on issues arising from the bright-line extension, including how new builds would be exempted from that extension.

17. Since March, much work has been undertaken on the detail of the proposals. Rules have been developed so that the interest limitation reforms will apply to the types of property that people might buy to live in but will not over-reach. It is also important to ensure that the reforms do not unduly impede those who are building or buying newly constructed properties, so that the supply of housing is not disrupted.

18. Following consultation, we have decided it would be appropriate to allow interest deductions to those who are taxed on the sale of their properties, either under the bright-line test or another tax provision. In such cases, all income earned has been taxed, so all expenses that relate to that taxed income should be deductible at the time of sale.

The interest limitation rules will apply to the types of property that people might buy to live in…

19. The proposed reforms are targeted at properties that can function as long-term residences, such as houses or apartments. To determine what should be in scope of the interest limitation rule, the key focus is whether a property is of a type that would be suitable for long-term owner-occupation. We consider the following factors are a helpful starting point:

19.1 *Physical structure and configuration.* Is the property configured in such a way that an owner-occupier could live in it for the long-term? If not, how difficult would it be to configure the property for owner-occupation?

19.2 *Ease of conversion.* If a property is already configured for long-term residential accommodation, would an exclusion lead to properties being converted to qualify for this exclusion (conversion risk)? Are there many barriers to conversion?

19.3 *Existing regulatory frameworks.* Is the property subject to an existing regulatory framework with well-defined rules about who can live in it? For example, retirement villages and student hostels are subject to existing regulatory frameworks. If so, this may suggest that it would be difficult to convert the property to gain an exemption and that it is not suitable for owner-occupation.

20. We propose that the interest limitation proposal should apply to houses and apartments suitable for long-term accommodation, even if they are not currently used as such. Income tax should not play a role in determining whether a given property is used to provide long-term rental accommodation or short-stay accommodation. We do not want landlords converting their rental properties to short-stay accommodation to avoid being impacted by the reforms.

... but should not over-reach

21. We do not want interest limitation to apply to those who do not contribute to high house prices. Decisions about what should and should not be subject to interest limitation are not necessarily clear-cut and lines have had to be drawn. In doing so, we have tried to minimise boundary issues. To that end, we propose the following exclusions:

21.1 *Main home.* The reforms will not affect interest related to taxable income derived from a person's main home. People who rent out an extra bedroom in their main home or conduct work from a home office will not be affected by the reforms.

21.2 *Public, council, emergency and transitional housing.* To eliminate the risk of interest limitation reducing the supply of public, council, emergency or transitional housing, we propose that such housing will not be subject to interest limitation.

21.3 *Property not suitable for long-term owner-occupation.* We propose to exclude property that is not structurally suitable for long-term owner-occupation from the reforms, as they do not contribute to high house prices. These include property types used by businesses to provide commercial accommodation at scale (such as hotels, motels, hostels, and inns), rest homes, retirement villages and student accommodation (school hostels and accommodation provided by, or in conjunction with, a tertiary institution).

21.4 *Other businesses and organisations not primarily involved in accommodation.* The reforms should not get in the way of ordinary businesses and organisations not involved in residential property investment, as they do not contribute to high house prices. We propose that, generally, business premises, employee accommodation, farmland and care facilities (such as hospitals, convalescence homes, nursing homes, and hospices) will not be subject to interest limitation.

21.5 *Compliance costs*. Taxpayers can allocate debt to either residential or non-residential assets. Taxpayers that own small amounts of in-scope residential property incidental to their core business or function will usually be able to ensure they continue receiving interest deductions, but at a potentially high compliance cost. We therefore propose to exclude companies from the reforms unless they are residential property-rich or are controlled by a small number of shareholders. For the same reason, we propose to exclude Kāinga Ora – Homes and Communities and its wholly-owned subsidiaries from the reforms, as almost all of their assets would be excluded.

21.6 *Māori collectively-owned land*. We propose to exclude Māori collectively owned land and housing which is provided to iwi, hapū, and whānau members (for example papakāinga and kaumātua housing). These properties are not available on the ordinary housing market and their inclusion would not further the aims of interest limitation. The Government aims to improve housing outcomes for Māori, and an exclusion for housing provided by iwi and hapū to their members would further that objective. To that end, we propose exclusions for:

21.6.1 Māori customary land, Māori freehold land, Crown land reserved for Māori, and land set aside as a Māori reservation;

21.6.2 housing provided on land held by a Māori authority (or an entity eligible to be one) to a shareholder or beneficiary of that entity, meaning an iwi, hapū or whānau member; and

21.6.3 land held by a Māori authority (or entity eligible to be one) that was acquired under a Treaty settlement or a post-Treaty settlement mechanism, including where a leasehold interest in that land is held by a wholly-owned subsidiary.

Housing provided on these types of land is normally exclusively available to Māori who are part of the relevant iwi or hapū represented by the relevant Māori authority and does not affect the general housing supply. This exclusion also ensures that the process of Treaty settlements is not affected by the interest limitation rules.

21.7 *Property outside New Zealand*. The reforms should not apply to properties located outside New Zealand as it reduces complexity and because they do not impact New Zealand house prices.

People building and buying newly built properties will be exempt

22. To minimise the potential impacts of interest limitation on housing supply, there will be exemptions for people who add to the supply of housing. As noted above, Cabinet agreed in-principle that property developers would not be affected by the rules and could continue deducting their interest expenses. It also agreed that new builds would be exempt from the rules (with officials to consult on the details). Following consultation, we propose to expand those exemptions to further help supply and lower compliance costs.

23. We propose that the exemption for developers include all property development which results in the construction of a new build, whether or not it is done by a property developer. We also propose that residential property acquired for the purposes of a

business involved in dealing in, subdividing, developing, or building on land should qualify for the development exemption.

24. Cabinet directed officials to consult on three options for the duration of the new build exemption. Following consultation, we propose that the new build exemption will apply for both the initial and subsequent owners of a new build until 20 years after the date a code compliance certificate (CCC) is issued. A 20-year exemption reduces the impact interest limitation would have on new housing supply, while ensuring the exemption is not so broad that it undermines the objective of dampening house price inflation.

25. We also propose a small change to Cabinet's in-principle decision that only properties purchased on or after 27 March 2021 and which were first purchased within 12 months of receiving their CCCs could qualify for the new build exemption. This in-principle decision would have meant that any new build that received its CCC on or after 27 March **2020** could, depending on when it was acquired, potentially qualify for the exemption. To make the rules simpler, we propose that the new build exemption will apply to any new build that receives its CCC on or after 27 March 2020, regardless of when the property was acquired. This is easier both for taxpayers to apply and for Inland Revenue to administer, and ensures that identical properties are not treated differently.

26. An issue we have considered is whether an existing dwelling could qualify for the new build exemption if it has been remediated. This is a difficult question because of the boundary issues that arise. Some types of remediation clearly help prevent dwellings from dropping out of existing housing supply, such as required earthquake strengthening work or re-cladding a leaky building. However, a rule that is too broad, and allows existing dwellings that haven't been significantly remediated to qualify for an exemption, could undermine the overall objective of the interest limitation rule. At this stage we do not propose to exempt existing dwellings that have been remediated but officials will do more work on options for how this might be achieved without undermining the broader policy.

Purpose-built rentals

27. Purpose-built rentals (PBRs), also known as build-to-rent, are large-scale property developments held in unified ownership with the intention of retaining the properties as long-term rentals. There are few existing PBRs as it is not yet a well-established sector in New Zealand. Like other newly built residential property, PBRs will be eligible for the development exemption while they are being built, and for the new build exemption for 20 years. However, the PBR industry believe that a carve-out is necessary, because the prospect of interest deductions being denied upon expiration of the new build exemption would reduce the likelihood of PBRs being constructed.

28. There is no pre-existing statutory definition for PBRs in New Zealand. As such, a definition of PBR would need to be created for the purposes of an exclusion from the interest limitation rules. s 9(2)(f)(iv) [redacted]

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

Te Tūāpapa Kura Kāinga - Ministry of Housing and Urban Development comment

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

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

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

Inland Revenue comment

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

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

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

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

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

Interest deductions should be allowed if a sale is taxed

36. Cabinet had agreed that officials would consult on whether interest deductions should be denied or merely deferred if the property is taxed on sale under the bright-line test or another provision. Following consultation, we propose that in such a case, the interest deductions will be allowed in the year of sale. The reason is that all of the income from owning the property (including the gain on sale) will have been taxed.

37. If a bright-line sale results in a loss, there is currently a rule that restricts deducting that loss against income other than taxable real property gains. We propose that the existing rule be extended to include losses arising from deferred interest deductions being allowed on sale.

Bright-line issues

38. The bright-line test imposes tax when residential land, other than the main home, is bought and sold within a specified period. On 30 March 2021, the bright-line period was extended from five years to ten years for property acquired on or after 27 March 2021. Cabinet noted that officials would consult on some bright-line issues that would benefit from stakeholder consultation. In summary, those issues are:

    38.1 *New build exemption from bright-line extension.* Cabinet agreed to exempt new builds acquired on or after 27 March 2021 from the extended bright-line test and directed officials to consult on the exemption. Apart from its length, we consider that the settings that apply for the ten-year bright-line test should also apply for the five-year new build bright-line test.

38.2 *Main home exclusion.* To ensure the main home is never taxed under the bright-line test, we will amend the main home exclusion for properties acquired on or after 27 March 2021. The exclusion currently applies only if a property is predominantly used as a main home. We will ensure that if a property is not predominantly used as a main home (for example, if there is a rental property that takes up a greater area on the same land), apportionment will apply so that the property used as the main home is not taxed.

38.3 *Rollover relief.* The bright-line test is triggered when there has been a legal change of ownership. Unfairness may arise if there has been a legal transfer but economic ownership remains unchanged. For example, a reorganisation for non-tax reasons can trigger the bright-line test and create a tax liability. We therefore propose to provide rollover relief for certain transfers (which, in effect, ignores the transfer for tax purposes). Relief would be provided for some transfers to family trusts, and to or from look-through companies and partnerships. Specific relief will also be provided for transfers to trusts constituted under the Te Ture Whenua Māori Act 1993 (given they typically have wider beneficiary classes as a result of succession and restrictions on alienating Māori land) and transfers to a trust of land as part of the settlement of a claim under te Tiriti o Waitangi – the Treaty of Waitangi.

Additional policy decisions

39. The proposed reforms involve a lot of detail, largely because of their interaction with other parts of the tax system. In addition to the design decisions already mentioned, there are many other more technical decisions needed. In particular, decisions are needed to:

39.1 prevent people from engaging in tax avoidance to get around the rules;

39.2 ensure that the rules work with other parts of the tax system; and

39.3 deal with transition issues and other minor details.

40. The key policy decisions for interest limitation and bright-line issues are covered in this paper. We propose that Cabinet authorise the Minister of Finance and Minister of Revenue to make additional joint decisions on any policy and drafting issues arising from the interest limitation proposal or additional bright-line changes in consultation with the Minister of Housing and Minister for Land Information as appropriate.

Implementation

41. The table below sets out the upcoming milestones for the reforms set out in this paper.

Milestone	Timeframe
Cabinet approval of policy and delegation to release SOP	27 September 2021

Milestone	Timeframe
Public release of SOP to the Taxation (Annual Rates for 2021–22, GST and Remedial Matters) Bill	28 September 2021
Finance and Expenditure Committee (FEC) calls for submissions on the SOP	29 September 2021
Application date for the interest limitation changes	1 October 2021
FEC submissions close	10 November 2021
Bill reported back from FEC	early March 2022
Third reading and Royal Assent	before 31 March 2022

42. Although the application date will be retrospective, taxpayers will not have to file their tax returns until after the end of their income year. For almost all taxpayers, the reforms will affect their income year ended 31 March 2022, for which returns and payments are not due until May 2022 at the earliest.[5] Moreover, the key features of the proposed reforms were announced in March 2021 and have been widely publicised since then, so most taxpayers should be aware of the changes.

Financial Implications

43. The estimated revenue gain from the interest limitation reforms is $1.12 billion between 1 July 2022 and 30 June 2025, with more revenue generated in the later years. This is largely due to the phased implementation of the reforms for existing rental properties.

	$ millions - increase/(decrease)			
Vote Revenue Minister of Revenue	**2021/22**	**2022/23**	**2023/24**	**2024/25**
Tax revenue: Income tax	80.000	200.000	350.000	490.000

44. The revenue will then decline from 2026 as investment is increasingly reallocated towards new builds.

45. The revenue estimate is uncertain due to the assumptions and projections involved, as well as the interaction with other parts of the tax system. The actual revenue gain will depend on broader macroeconomic factors such as the trend of future interest rates and house prices. Behavioural impacts, including how the reforms may impact investors' preferences for existing rental properties compared to new builds or other investments, will also affect the estimate.

46. If rents increase, the tax reforms may also lead to an increase in spending on the accommodation supplement and temporary additional support. However, it is difficult to quantify this impact at this stage.

5 Returns for taxpayers with a standard 31 March 2022 balance date will be due in July 2022. However, the new interest limitation rules could affect the amount of their third provisional tax payment, due in May 2022.

Administrative implications

47. Implementation and administration of the reforms will increase workloads for Inland Revenue over an extended period of time. Apart from capital costs required to design and implement the solutions, further costs will arise from managing an increased number of customer contacts, investing in good data and analytics to assist in monitoring the policy, and supporting the integrity of the rules. Inland Revenue will initially focus on providing customers and third parties with clear information and assistance to support accurate self-assessments and return filing. Automated analytic and intervention capabilities will be deployed, with follow-up activity for cases of obvious deliberate non-compliance.

48. A summary of the estimated incremental administrative costs over four years are provided in the table below:

	$m – increase/(decrease)			
Vote Revenue	**2021/22**	**2022/23**	**2023/24**	**2024/25**
Capital	**1.400**	**-**	**-**	**-**
Operating	3.580	5.920	5.260	4.620
Depreciation & Capital Charge	0.050	0.200	0.200	0.200
Total operating	**3.630**	**6.120**	**5.460**	**4.820**

49. Inland Revenue is seeking funding totalling $19.380 million to cover the operating cost (excluding depreciation and capital charge) for the period 2021/22 to 2024/25. The department considers this amount sufficient to support the forecast revenue gain. Modelling for 2025/26 and subsequent periods indicates there will be further costs in the out-years. Inland Revenue intends to raise these as part of future budget discussions, by which time more certainty will exist.

50. Inland Revenue will use its accumulated depreciation reserves to fund the capital costs required to develop and integrate the solution. The use of $1.400 million of these reserves will not materially affect Inland Revenue's ability to fund the replacement of existing assets in the future. Since Inland Revenue is self-funding the capital costs, it is not seeking funding for the associated depreciation and capital charge.

51. Inland Revenue will report to the Minister of Finance and Minister of Revenue annually on the effect of this funding on taxpayers' compliance with the interest limitation rules and changes to the bright-line rules.

Legislative Implications

52. Implementing these reforms will require changes to the Income Tax Act 2007.

53. We propose to include the legislative changes for these reforms in a Supplementary Order Paper (SOP) to the Taxation (Annual Rates for 2021-22, GST, and Remedial

Matters) Bill. This paper seeks Cabinet's agreement to delegate authority to the Minister of Revenue, in consultation with the Leader of the House, to release an SOP containing these reforms at the Finance and Expenditure Committee stage of the Bill.

54. The Taxation (Annual Rates for 2021-22, GST, and Remedial Matters) Bill holds a category 4 priority on the 2021 Legislation Programme (to be referred to a select committee in 2021).

Impact Analysis

Regulatory Impact Assessment

55. The Quality Assurance Panel with representatives from Inland Revenue and the Treasury has reviewed the *Limiting interest deductibility on residential investment property* regulatory impact statement (RIS) prepared by Inland Revenue and considers that the information and analysis summarised in the RIS partially meets the quality assurance criteria.

56. Assessing the impact of each option depends on judgements about how much and how quickly housing supply responds to economic signals such as price. Further, the timeframe for policy development has been constrained. Given this, the panel considers that the information in the RIS is as complete as could reasonably be expected and identifies the main judgements, risks and uncertainties within the policy.

57. However, the RIS does not analyse the impacts of the interest limitation policy in conjunction with other measures that have been recently implemented or are being considered. Further, while public consultation was carried out on the design of the proposal to limit interest deductibility, the public have not specifically been consulted on the problem definition and the broader range of options (although where stakeholders provided general comments on the proposal and suggested alternatives through the public consultation process, these comments have been incorporated into the RIS). Consequently, the panel cannot be confident that the full range of impacts have been identified or that the preferred options are the best options to address the problem and achieve the desired objectives.

Climate Implications of Policy Assessment

58. The Climate Implications of Policy Assessment (CIPA) team has been consulted and confirms that the CIPA requirements do not apply to any of the proposals in this paper as the threshold for significance has not been met.

Population Implications

59. The number of taxpayers likely to be directly affected by the interest limitation proposal is estimated to be around 250,000.

60. We also expect the proposal to have indirect impacts on other parts of the population. The proposal is likely to put downward pressure on house prices and upward pressure on rents. The size of these impacts is unclear. In particular, there are differing views on the likely impact of the interest limitation proposal on rents, which is complex and uncertain. Rents can be affected by a number of factors including the costs to property

investors, renters' ability to pay, and the responsiveness of housing supply to changes in the price of housing.

61. The size of the proposal's impacts on house prices and rents will determine how the following population groups are likely to be affected:

61.1 *Children.* The potential for increased affordability for first home buyers is likely to benefit the children of first home buyers who are parents. However, in 2013, around 43% of children were living in rental accommodation.[6] Upward pressure on rents could have negative effects on children in rental accommodation, thereby impacting child wellbeing and child poverty.

61.2 *Māori and Pacific people.* Māori and Pacific people are less likely to own their home (or hold it in a trust) than other ethnic groups. In 2018, the proportion of Māori and Pacific people living in owner-occupied homes were 47.2% and 35.1% respectively, compared to the total population figure of 64.3%. To the extent that the proposal places upward pressure on rents, it appears likely to disproportionately impact Māori and Pacific people. However, some Māori people who do not live in owner-occupied homes instead live in papakāinga and kaumātua housing. As explained above, we propose to exclude those types of properties from the reforms. In addition, the Government is taking other measures to improve housing for Māori and Pacific, including through Whai Kāinga Whai Oranga, Progressive Home Ownership, Māori and Iwi Housing Innovation (MAIHI) partnerships and our Public Housing build programme.

62. As noted above, the magnitude of the effect of the interest limitation proposal on house prices and rents is uncertain, so the size of the impact on population groups described above is also uncertain. The Ministry of Housing and Urban Development monitors market impacts, including on the rental market, closely and will continue to do so after the reforms. This monitoring can help assess whether further interventions may be necessary.

63. Furthermore, officials will report to the Ministers for Child Poverty Reduction, Finance, Housing, Social Development and Employment, and Revenue on options for changes to family and housing support as part of the welfare overhaul, particularly as part of the Working for Families and Accommodation Supplement review.

Human Rights

64. The proposals comply with the rights and freedoms contained in the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Consultation

65. Inland Revenue, the Treasury and Te Tūāpapa Kura Kāinga - Ministry of Housing and Urban Development worked closely together in the development of the proposed reforms. Officials have also consulted with Land Information New Zealand, Te Puni Kōkiri, Ministry for Culture and Heritage and Kāinga Ora.

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6 Johnson, Howden-Chapman and Eaqub *A Stocktake of New Zealand's Housing* (February 2018) <www.beehive.govt.nz> at 40.

66. The Government released a public discussion document on the proposed reforms in June. Consultation was open for more than four weeks and 484 submissions were received. The majority of submitters were private landlords, although some were from tax advisors, property investor representative groups, real estate agents, iwi groups, and property developers. Submissions were generally opposed to the reforms.

67. Officials also undertook targeted consultation with a smaller number of interested stakeholders both before and after the release of the discussion document.

Communications

68. The in-principle decisions made by Cabinet were announced in March 2021.

69. We will make an announcement on the contents of the SOP containing the proposed reforms when the SOP is released on 28 September 2021. Fact sheets and questions and answers will be provided to help those affected understand the legislation. Bill commentary for the SOP will also be released shortly after.

70. Inland Revenue will also include details of the new legislation in guidance as soon as practicable after the Bill is enacted.

Proactive Release

71. We propose to proactively release this Cabinet paper, associated minutes, and key advice papers with appropriate redactions within 30 working days of Cabinet making final decisions.

Recommendations

The Ministers of Finance, Housing and Revenue recommend that Cabinet:

1. **agree** to the following modifications of the decisions made on 8 March 2021 (CAB-21-MIN-0045):

    1.1 apart from length, the settings that apply for the extended bright-line test will also apply for the new build bright-line test (paragraph 25);

    1.2 the new build exemption from interest limitation will apply to any qualifying new build that receives its code compliance certificate on or after 27 March 2020, even if the property is acquired before this date (paragraph 29);

2. **confirm** the in-principle decisions made on 8 March 2021, other than those listed at paragraph 1 above;

Scope and exclusions

3. **agree** that, as a general principle, interest limitation will apply to properties suitable for long-term accommodation even if they are not currently being used as such;

4. **agree** that the main home will not be subject to interest limitation;

5. **agree** that public, council, emergency, and transitional housing will not be subject to interest limitation;

6. **agree** that, as a general principle, property not suitable for long-term owner-occupation should not be subject to interest limitation;

7. **agree** that, as a general principle, businesses and organisations not involved in residential property investment should not be subject to interest limitation;

8. **agree** that companies will not be subject to interest limitation unless they are residential property-rich or controlled by a small number of shareholders;

9. **agree** that Kāinga Ora – Homes and Communities and its wholly-owned subsidiaries will not be subject to interest limitation;

10. **agree** that the interest limitation proposal will not apply to:

    10.1 Māori customary land, Māori freehold land, Crown land reserved for Māori, and land set aside as a Māori reservation;

    10.2 housing provided on land held by a Māori authority (or an entity eligible to be one) to a shareholder or beneficiary of that entity; or

    10.3 land held by a Māori authority (or an entity eligible to be one) that was acquired under a Treaty settlement or a post-Treaty settlement mechanism, including a leasehold interest in that land is held by a wholly-owned subsidiary.

11. **agree** that properties located outside New Zealand will not be subject to interest limitation;

Property development and new builds

12. **agree** that taxpayers undertaking property development will not be subject to limitation on interest expenses relating to that development as incurred, even if they are not property developers;

13. **agree** that interest deductions relating to residential property acquired for the purposes of a business involved in dealing in, subdividing, developing, or building on land also should not be subject to limitation;

14. **agree** that the new build exemption will apply to the first purchaser and subsequent purchasers of a new build until 20 years after the new build's code compliance certificate is issued;

Purpose-built rentals

15. **agree** that purpose-built rentals:

    EITHER

    15.1 should be subject to the interest limitation rules (including the development and 20-year new build exemptions, which would apply to new purpose-built rentals);

OR

15.2 should be excluded from the interest limitation rules.

Interest deductions when property is taxed on sale

16. **agree** that if a residential property is taxed on sale, previously limited interest deductions relating to that property will be allowed on sale;

17. **agree** that if a residential property is taxed on sale under the bright-line test, any losses arising from the deferred interest deductions being allowed will be subject to the existing restrictions applying to bright-line losses;

Bright-line issues

18. **agree** to amend the main home exclusion for properties acquired on or after 27 March 2021, so that where land is not used predominantly as a main home, the main home portion of the land is not taxed under the extended or new build bright-line tests;

19. **agree** that**,** as a general principle, legal transfers where there is no change in economic ownership should not trigger the bright-line test;

Additional policy decisions

20. **agree** to delegate authority to the Minister of Finance and Minister of Revenue to make additional joint decisions on any policy and drafting issues arising for the interest limitation proposal or additional bright-line changes in consultation with the Minister of Housing and Minister for Land Information as appropriate;

Financial implications

21. **note** the following changes in tax revenue as a result of decisions in recommendations 1 to 20 above, with a corresponding impact on the operating balance and net core Crown debt:

	$m – increase/(decrease)			
Vote Revenue **Minister of Revenue**	**2021/22**	**2022/23**	**2023/24**	**2024/25**
Tax revenue: Income tax	80.000	200.000	350.000	490.000

22. **agree** that the changes in tax revenue under recommendation 21 above are managed against the Budget 2022 operating allowance, which can be used to increase total gross spending for Budget 2022, while not increasing overall allowances for Budget 2022.

23. **note** that the revenue impacts will continue beyond the current forecasting period (2024/25) and that these will be reflected in the operating balance and net core Crown debt at appropriate future dates.

24. **note** that any rent increases arising from the interest limitation reforms may also lead to an increase in Crown spending on the accommodation supplement and temporary additional support, which is difficult to quantify at this stage;

25. **note** that to give effect to the policy decisions in recommendations 1 to 20, Inland Revenue will incur capital costs of $1.400 million;

26. **note** that Inland Revenue will cover the associated depreciation and capital charge from its existing baseline funding;

27. **note** that Inland Revenue will self-fund these capital costs from its accumulated reserves and that this will not materially affect the department's ability to fund the future replacement of its existing assets;

28. **note** that a further effect of the policy decisions will be to increase the outreach, assistance, compliance and policy work expected of Inland Revenue and that it is consequently seeking funding totalling $19.380 million to cover operating costs (excluding depreciation and capital charge) for the period up to 30 June 2025;

29. **approve** the following changes to appropriations to help meet the costs identified at recommendation 28 above, with the corresponding impact on the operating balance and net core Crown debt:

	$m – increase/(decrease)			
Vote Revenue	**2021/22**	**2022/23**	**2023/24**	**2024/25**
Multi-Category Expenses and Capital Expenditure: Services for Customers MCA				
Investigations (funded by revenue Crown)	0.330	2.000	2.000	2.000
Management of debt and unfiled returns (funded by revenue Crown)	-	0.380	0.380	0.380
Services to Ministers and to inform the public about entitlements and meeting obligations (funded by revenue Crown)	2.390	2.430	2.020	1.590
Services to process obligations and entitlements (funded by revenue Crown)	0.860	0.860	0.860	0.650
Departmental Output Expenses:				
Policy Advice (funded by revenue Crown)	-	0.250	-	-
Total operating	**3.580**	**5.920**	**5.260**	**4.620**

30. **agree** that the expenses incurred under recommendation 29 be charged against the operating allowance of the Between-Budget Contingency;

31. **agree** that the changes to appropriations in 2021/22 above be included in the 2021/22 Supplementary Estimates and that, in the interim, the increases be met from Imprest Supply;

32. **note** that Inland Revenue intends to raise funding for out-years beyond 2024/25 in future Budget discussions, by which time more certainty will exist;

33. **direct** Inland Revenue to report to the Minister of Finance and Minister of Revenue annually on the effect of this funding on taxpayers' compliance with the interest limitation rules and the changes to the bright-line rules.

Legislative implications

34. **agree** to delegate authority to the Minister of Revenue, in consultation with the Leader of the House, to release a Supplementary Order Paper containing the measures in recommendations 1 to 19 at the Finance and Expenditure Committee stage of the Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Bill.

Authorised for lodgement

Hon Grant Robertson
Minister of Finance

Hon Megan Woods
Minister of Housing

Hon David Parker
Minister of Revenue