Hon Grant Robertson, Minister of Finance

Hon Dr Megan Woods, Minister of Housing

Hon David Parker, Minister of Revenue

Information Release

Taxation of housing: limiting interest deductions for residential property and changes related to the bright-line extension

May 2022

Availability

This information release is available on Inland Revenue's tax policy website at https://taxpolicy.ird.govt.nz/publications/2022/2022-ir-interest-limitation

Documents in this information release

#	Reference	Type	Title	Date
01	IR2021/133 T2021/847	Tax policy report	Interest limitation proposal – consultation, timing, and scope of consultation document	1 April 2021
02	IR2021/181	Tax policy report	Interest limitation proposal – further scope and design issues	27 April 2021
03	IR2021/231 T2021/1377	Tax policy report	Discussion document – design of the interest limitation rules and additional bright-line rules	27 May 2021
04	CAB-21-SUB-0204	Cabinet paper	Release of discussion document – design of the interest limitation and additional bright-line rules	8 June 2021
05	CAB-21-MIN-0204	Minute	Design of the interest limitation and additional bright-line rules: release of discussion document	8 June 2021
06	IR2021/325 T2021/1935	Tax policy report	Interest limitation on residential investment property – key policy issues	29 July 2021
07	IR2021/341 T2021/2180	Tax policy report	Interest limitation on residential investment property and associated bright-line changes – final policy recommendations	25 August 2021
08	BRF21/22081081	Briefing	Social housing exemption from interest limitation – sunset clause	26 August 2021

#	Reference	Type	Title	Date
09	IR2021/382 T2021/2316 BRF21/22091096	Tax policy report	Cabinet paper – taxation of housing: limiting interest deductions for residential property and changes related to the bright-line extension	9 September 2021
10	DEV-21-SUB-0181	Cabinet paper	Taxation of housing: limiting interest deductions for residential property and changes related to the bright-line extension	22 September 2021
11	DEV-21-MIN-0181	Minute	Taxation of housing: limiting interest deductions for residential property and changes related to the bright-line extension	22 September 2021
12	CAB-21-MIN-0385	Minute	Taxation of housing: limiting interest deductions for residential property and changes related to the bright-line extension	27 September 2021

Additional information

Cabinet paper ***Release of discussion document – design of the interest limitation and additional bright-line rules*** (CAB-21-SUB-0204) was considered and confirmed by Cabinet on 8 June 2021.

Cabinet paper ***Taxation of housing: limiting interest deductions for residential property and changes related to the bright-line extension*** (DEV-21-SUB-0181) was considered by the Cabinet Economic Development Committee on 22 September 2021 and referred to Cabinet for further discussion on 27 September 2021.

Four attachments to the Cabinet papers are not included in this information release as they are publicly available:

- Design of the interest limitation rule and additional bright-line rules: a Government discussion document and summary sheets (10 June 2021)[1]
- Regulatory impact statement – Limiting interest deductibility on residential investment property (8 September 2021)[2]
- Supplementary departmental disclosure statement for Supplementary Order Paper No 64 to the Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Bill (27 September 2021)[3]
- Supplementary Order Paper No 64 to the Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Bill (28 September 2021)[4]

[1] Available at https://taxpolicy.ird.govt.nz/publications/2021/2021-dd-interest-limitation-and-bright-line-rules
[2] Available at https://taxpolicy.ird.govt.nz/publications/2021/2021-ris-interest-deductibility
[3] Available at http://disclosure.legislation.govt.nz/sop/government/2021/64/
[4] Available at https://legislation.govt.nz/sop/government/2021/0064/latest/whole.html

Information withheld

Some parts of this information release would not be appropriate to release and, if requested, would be withheld under the Official Information Act 1982 (the Act). Where this is the case, the relevant sections of the Act that would apply are identified. Where information is withheld, no public interest was identified that would outweigh the reasons for withholding it.

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Inland Revenue
Te Tari Taake

POLICY AND REGULATORY STEWARDSHIP

TE TAI ŌHANGA
THE TREASURY

Tax policy report: **Interest limitation proposal – consultation, timing, and scope of consultation document**

Date:	1 April 2021	**Priority:**	Medium
Security level:	In Confidence	**Report number:**	IR2021/133 T2021/847

Action sought

	Action sought	Deadline
Minister of Finance	**Indicate** your preferred recommendations **Refer** this report to the Minister of Housing	9 April 2021
Minister of Revenue	**Indicate** your preferred recommendations	9 April 2021

Contact for telephone discussion (if required)

Name	Position	Telephone
Felicity Barker	Team Leader, Treasury	s 9(2)(a)
Chris Gillion	Policy Lead, Inland Revenue	

1 April 2021

Minister of Finance
Minister of Revenue

Interest limitation proposal – consultation, timing, and scope of consultation document

Executive summary

Officials propose to report to you with a consultation document in late May on the design details of limiting interest deductions for residential property. This report seeks your direction on both the timing of consultation and the timeline for making final policy decisions (and for the resulting legislation).

This report also seeks your agreement on which options to include in the consultation document in respect of a small number of design issues. Clarifying the scope of the consultation early on would allow officials to concentrate their efforts on second-order decisions and help focus submissions on areas where consultation is likely to be most helpful.

The key decisions covered in this report are:

- **Treatment of denied interest deductions when property is sold.** Cabinet has already agreed that officials will consult on whether interest deductions should be denied or merely deferred if the taxpayer is not a property developer but is taxed on the disposal of their property under the bright-line test or another land sale rule. Officials seek guidance on the range of options to be included in the discussion document.
- **Interest allocation approach.** This is the method by which taxpayers work out which interest deductions are impacted. Officials recommend that tracing be the approach generally used for all taxpayers (whether a company or not). This approach means that the limitation of interest deductions depends on whether the borrowed funds are used for residential property purposes. It also means that businesses borrowing for non-residential property purposes are unaffected by the rules, even if the borrowing is secured over a residential property. However, there are integrity and fairness issues with the tracing approach. There are other possible options set out in the Appendix. Officials seek agreement as to what methods should be included in the consultation.
- **Application to widely held companies**. Officials recommend applying the rules to all close companies and only "residential land-rich" widely held companies. This would ensure that companies holding small amounts of residential land incidental to their primary business are unaffected by the rules. This approach means interest deductions of retirement village operators could be denied, depending on how broadly a "residential land-rich" company is defined, unless there is an exception for them.[1] Officials seek clarification on what should be included in the consultation.

Recommended action

We recommend that you:

[1] Retirement villages are already carved-out from application of the bright-line rule under the definition of "residential land" and this approach could be replicated for the interest denial rule.

A. **agree** to the proposed consultation timeframe, with officials reporting to you with a consultation document in late May.

Agreed/Not agreed Agreed/Not agreed

B. **agree** to consultation beginning with a small group of stakeholders before the public release of the consultation document.

Agreed/Not agreed Agreed/Not agreed

C. **note** that consistent with the Cabinet agreement the consultation document will include an option that interest deductions may be deductible on a deferred basis if the taxpayer is taxed on the disposal of their property.

D. **agree** to consult on the further option of allowing interest deductions when a property is sold, if the sale is not taxable, to the extent that interest deductions exceed any untaxed gains.

Agreed/Not agreed Agreed/Not agreed

E. **indicate** which interest allocation option(s) you would like included in the consultation document:

1. Tracing (where interest is traced to what the borrowed funds were used for) (*recommended*).

Agreed/Not agreed Agreed/Not agreed

2. Stacking (where debt is allocated to assets in accordance with a prescribed order) (*not recommended*).

Agreed/Not agreed Agreed/Not agreed

3. Apportionment (where debt is allocated to assets in proportion to the value or cost of the assets) (*not recommended*).

Agreed/Not agreed Agreed/Not agreed

F. **indicate** which of the following scope option(s) for application to companies you would like included in the consultation document:

1. Close companies only.

Agreed/Not agreed Agreed/Not agreed

2. Close companies and "residential land-rich" companies (*recommended*).

Agreed/Not agreed Agreed/Not agreed

3. All companies.

Agreed/Not agreed Agreed/Not agreed

G. **indicate** your preference for when decisions on the design of limiting interest deductions are to be made public, noting that making decisions before 1 October 2021 will mean limiting the time for public consultation.

Before 1 October/After 1 October Before 1 October/After 1 October

H. **indicate** which of the legislative timing options you would like for the housing measures to be introduced:

1. Option 1: include the housing measures in a Supplementary Order Paper to the annual rates omnibus tax Bill (AR Bill) at the Finance and Expenditure Committee stage on 14 October 2021 (*recommended*).

Agreed/Not agreed Agreed/Not agreed

2. Option 2: introduce the housing measures as a standalone Bill on 19 October 2021.

Agreed/Not agreed Agreed/Not agreed

3. Option 3: delay the introduction of the AR Bill until 19 October and include the housing measures in that Bill on introduction (not recommended).

Agreed/Not agreed Agreed/Not agreed

I. **refer** a copy of this report to the Minister of Housing.

s 9(2)(a)

[redacted]

Felicity Barker
Team Leader
The Treasury

Chris Gillion
Policy Lead
Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2021

Hon David Parker
Minister of Revenue
/ /2021

Purpose

1. This report seeks joint Ministers' agreement on a proposed approach for consulting with stakeholders on the design details of the interest limitation proposal that was announced on 23 March, as well as seeking direction on the timeframe for making final policy design decisions and legislative options.

2. This report also seeks your agreement on which options officials will consult on for the interest limitation proposal regarding:

    2.1 the treatment of interest deductions when the property is sold,

    2.2 the interest allocation approach, and

    2.3 the application of the rules to widely held companies.

3. Officials intend to put forward "proposed" approaches on the above topics in a consultation document and invite submissions on the details of how those approaches will be applied.

4. Officials will report to you subsequently on a possible policy framework to help guide other important design decisions for the interest limitation proposal.

Background

5. On 8 March 2021, Cabinet agreed in-principle to limit deductions for interest incurred to earn income from residential property (CAB-21-Min-0045 refers). Cabinet also directed officials to consult with stakeholders on the design details of the interest limitation proposal before seeking final decisions from Cabinet.

6. Officials propose that the public consultation document on the interest limitation proposal is released in late May 2021, or shortly thereafter. Given the timeframes involved and the fact that some key design decisions will impact many second-order design decisions, it would be useful to get some key design decisions agreed and thereby reduce the number of issues out for consultation.

7. Limiting the scope of the consultation document in this way would allow officials to concentrate their efforts on second-order decisions and can help focus submissions on areas where consultation is likely to be most helpful.

Consultation and Timing

Timing of consultation

8. Officials are currently drafting a consultation document and propose providing you this consultation document in late May for release soon after. Cabinet directed officials to consult with stakeholders on the design of the interest limitation proposal before seeking final decisions from Cabinet. We propose to allow six weeks for submissions on the consultation document.

9. Officials also propose beginning consultation now. There are a wide range of interested and affected stakeholders that we are interested in engaging with. We will be leveraging off the Ministry of Housing and Urban Development's industry and interest group networks to ensure we reach those stakeholders.

10. We propose to adopt a similar approach to consulting on the design of the rules for interest deductibility as we did when designing the temporary loss carry back rules last year (in response to Covid-19). Under this approach we established a group of tax experts to assist in the technical design of the rules. The benefit of this approach is that we involve practitioners in promptly designing rules that are effective and

simple to implement. This expert group will be formed and consulted prior to the consultation document to help inform its contents.

Timing for decision making

11. After considering submissions on the consultation document, we will report to you with final policy recommendations. The amount of time allowed for consultation will determine when we can report back to you and when final policy decisions will need to be made. If officials' proposed timing is adopted (with six weeks of consultation), we will be able to report back to you in early September 2021 and expect that final policy decisions will be made by Cabinet on 4 October 2021.

12. This proposed timeline for making final decisions would mean that the design of the measure to limit interest deductions for residential property will not be public until after the date from which the measure begins denying deductions (1 October 2021). While tax returns that deny interest deductions will not be filed until after 31 March 2022, this uncertainty around the policy at 1 October 2021 may cause concern for some residential property investors.

13. Officials can discuss alternative timeframes for consultation and decision making with you if you wish. However, in order to have decisions on design details be made public by 1 October, there will likely need to be a reduction in time for consultation, which could harm the design of the policy.

Legislative vehicle

14. Officials' preferred timeframe for making final decisions is later than the originally planned introduction of the annual rates omnibus tax Bill (AR Bill) that also must be enacted by 31 March 2022. There are three options to have the contents of the AR Bill and the housing proposals enacted by 31 March 2022.

15. **Option 1** is to introduce the AR Bill, as originally planned, on 31 August 2021 and include the housing proposals via a Supplementary Order Paper (SOP) to the Finance and Expenditure Committee (FEC) on 14 October 2021. This is officials' preference for the following reasons:

    15.1 It maintains a full 6-week FEC submission period for both the AR Bill content and the housing proposals.

    15.2 It allows the bulk of the AR Bill FEC submissions to be considered in advance of the housing FEC submissions closing – this frees up resources to consider housing submissions in a shortened timeframe.

    15.3 Within the shortened timeframes of all three options, it provides the lowest risk of significant errors in the FEC process.

    15.4 It minimises the resource commitment of the FEC and Parliament who will only need to consider a single bill.

16. **Option 2** is to introduce the AR Bill, as originally planned, on 31 August 2021 with a separate bill for the housing proposals introduced on 19 October. This follows similar timelines to option 1 but has three main differences which, on balance, make it officials' second preference:

    16.1 It removes a perception risk that the housing proposals are being introduced by SOP which could (incorrectly) be viewed as reducing the opportunity for consultation.

    16.2 Due to the longer process for the Government to approve the introduction of a bill compared with Ministers releasing an SOP under delegated authority, there will be more decisions to be made by Ministers and less time to consider those decisions.

16.3 It will require FEC to consider two tax bills, rather than one, during February 2022 and Parliament to consider two tax bills, rather than one, to pass through all remaining stages during March 2022.

17. **Option 3** is to delay the introduction of the AR Bill so that the housing proposals can be included before it is introduced on 19 October. This avoids any negative perception issues with using an SOP and minimises FEC and house time. However, it has a number of significant risks and drawbacks so is not recommended. These include:

17.1 Even if officials provide you with the Bill the day after the housing policy is agreed by Cabinet, there will only be 12 days for you to consider the Bill, consult with Caucus, lodge the Bill with the Cabinet office and have it agreed by Cabinet. This is the same timeline for approval of a housing Bill under option 2 but the content of the Bill will be much larger.

17.2 This timeline assumes the Bill can complete its first reading on the first possible date of 26 October. If this is not completed, FEC submissions will not close until 22 December. This will make points 17.3 and 17.4 below worse.

17.3 FEC submissions are planned to close on 8 December. This only provides officials with approximately 8 weeks, including Christmas, to consider all submissions (including late submissions), reach agreement with the Independent Advisor to FEC, finalise the officials' report and prepare near-final revision tracked legislation. This is significantly shorter than previous omnibus tax bills and, despite officials' best efforts, is likely to result in a number of errors, particularly as we expect there will be a large number of submissions on the housing measures in the Bill.

17.4 This significantly shorter consultation period is likely to create a perception that the Government and officials are not taking the FEC consultation period seriously as the short timeframe is likely to result in insufficient time to consider and respond to submissions resulting in the reported back version being more similar to the introduction version than would occur under normal timeframes.

18. The relevant dates for each option are shown in Table 1 on the following page.

Table 1. Timeframes under three legislative options

	Option 1 Aug intro/Oct SOP (1st preference)	Option 3 Two Bills (2nd preference)	Option 2 Oct intro (not recommended)
AR Bill provided to Minister	5 August 2021	5 August 2021	6 October 2021
AR Bill approved by CAB (intro next day)	30 August 2021	30 August 2021	18 October 2021
Housing Bill provided to Minister		6 October 2021	
Housing SOP released	14 October 2021		
Housing Bill approved by CAB (intro next day)		18 October 2021	
AR Bill submissions close	20 October 2021	20 October 2021	8 December 2021
Housing submissions close	1 December 2021	8 December 2021	
FEC report back	3 March 2022	3 March 2022 (x2)	3 March 2022
Bill(s) enacted	31 March 2022	31 March 2022 (x2)	31 March 2022

Treatment of interest deductions when a property is sold

19. One of the questions for consultation agreed by Cabinet is how interest deductions that have been denied should be treated when the disposal of the property is taxed. One option that officials intend to consult on is allowing those deductions to offset any gain on sale that is taxable.

20. The case considered by Cabinet considers one situation where there are no untaxed gains but does not explicitly consider all such cases. Whenever income is fully taxed, there are grounds for considering allowing interest deductions on sale. The decision by Cabinet does not discuss situations where there are net losses on sale or where there are tax-free capital gains but these are smaller than the interest deductions that have been denied. A question for you is whether you want the consultation document to consider the treatment of interest deductions when there are net losses arising on sale or tax-free capital gains which are smaller than disallowed interest deductions.

21. Officials recommend extending consultation to cover situations where the disposal of a property either produces a loss, or a gain that is smaller than the amount of interest expense. This would mean putting multiple options in the consultation document for how to treat interest deductions that have been denied when the disposal of a property is taxed. These options could include the following, although other options, or variations on these, are also possible:

    21.1 Permanently denying interest deductions.

    21.2 Allowing interest deductions on a deferred basis if the taxpayer is taxed on the disposal of their property.

    21.3 Allowing interest deductions when a property is sold, if the sale is not taxable, to the extent that interest deductions exceed any untaxed gains.

This would mean interest deductions may be fully allowed where a property is sold for a capital loss.

Proposed interest allocation approach: tracing

22. In tax law, a deduction is generally allowed for expenditure or loss that is incurred in deriving assessable (taxable) income. This can be described as a 'nexus' approach, as the availability of a deduction depends on what the expenditure was used for. It is the default approach applied in the absence of any other specific rule.

23. Establishing nexus for interest expense can be difficult. Generally, a tracing approach is applied. If borrowed money is used to acquire an income producing asset or pay a deductible expense, the money can be directly traced to the production of taxable income, and the interest is deductible. If the borrowed money is used to acquire a family home or personal vehicle, or to fund a holiday, the interest is not deductible. In other cases, loan funding is used for purposes which do not relate directly to earning taxable income, such as repaying another loan, funding a dividend or payment of drawings to a business partner, or funding payment of a tax obligation. In these cases, tracing is more problematic. Tracing is also subject to manipulation. For example, an individual can use equity to fund private assets and borrowing to fund taxable assets. For these reasons, tracing is not generally applicable to interest expense incurred by companies.

24. There are already some specific tax rules that apply to interest allocated to residential property, namely the mixed-use asset (*MUA*) rules and the residential loss ring-fencing (*RLR*) rules. For taxpayers other than companies, the tracing approach is used under both the MUA and RLR rules. For companies, the RLR rules also use tracing but the MUA rules apply a different 'stacking' approach. An explanation of stacking and other possible approaches is outlined in the **Appendix**.

25. You have stated that your intention is for the interest limitation proposal not to affect non-housing loans (for example, loans for a small business operated by a sole trader and secured by residential property). Officials consider that the tracing approach is the most viable approach that is consistent with that intention.

26. However, because money is fungible, the tracing approach can cause fairness and integrity issues. This is shown in **Example 1** below. There may also be practical difficulties in applying tracing, particularly retrospectively (for example, it may be hard to trace how much of a loan was used for residential rental property purposes versus other business purposes, if the borrowed funds were used before application date).

Example 1 – Issues with tracing

Assume that the interest limitation proposal applies a tracing approach, such that interest deductions are denied for money borrowed to acquire a residential rental property.

Staffa Trust is a family trust, which owns a share portfolio worth $1M and no other assets or debt. Staffa Trust borrows $1M to acquire a residential rental property. Under the interest limitation proposal, Staffa Trust would not be allowed deductions for any of its interest expense.

Rota Trust is another family trust, which owns a residential rental property worth $1M and no other assets or debt. Rota Trust borrows $1M to acquire a share portfolio worth $1M. Rota Trust's interest deductions are not affected by the interest limitation proposal. Interest paid by Rota Trust on the $1M loan would remain fully deductible, as the borrowed funds were used in deriving assessable income.

This outcome raises issues of horizontal equity, as Rota Trust has exactly the same assets and liabilities as Staffa Trust. However, because Rota Trust used its existing equity to buy the residential rental property and it used debt to buy its share portfolio, it was able to retain its interest deductions. This example also illustrates the integrity problems caused by tracing, as taxpayers who own significant taxable assets (other than residential rental properties) will be able to limit the impact of the interest limitation proposal by equity-funding their rental properties and debt-funding their other taxable assets.

27. Alternative approaches could be used to avoid these issues, but such approaches are either overly generous or would deny (at least partially) interest deductions on loans incurred for the purpose of funding a small business. This is discussed further in the Appendix.

28. The interest allocation approach to be used is a key design decision that will impact many other second-order decisions that officials intend to consult on. For example, rules for taxpayers borrowing to acquire shares in a company that owns residential rental property may be designed very differently if a tracing approach is used than if a stacking approach is used.

29. Officials consider that getting early clarity on the interest allocation approach to be used will help to focus issues and allow more meaningful consultation on second-order design decisions. Officials recommend that tracing be the approach generally used for all taxpayers (whether a company or not) under the interest limitation proposal, noting that there may possibly be some limited instances where a different approach might be needed.

Application of the rules to widely held companies

30. Residential properties can be held by companies in many different situations. Some companies hold residential properties as part of their primary business. A landlord may use a company to hold all of their rental properties, for tax or non-tax reasons. Companies operating retirement villages own residential properties and sell licences to occupy to the village's residents.

31. A company may also have small holdings of residential property that are incidental to its core business. For example, an agricultural company may own residential properties near its farms or orchards and use them to provide accommodation to its workers. A large company may also own residential properties near its offices for employees to use when they have to travel from out of town, or for short secondments. A company may also own holiday homes that it allows employees to use as a perk.

32. To be effective, the interest limitation proposal must apply to residential properties held in "close companies" (companies where 5 or fewer individuals[2] hold more than 50% of the company). Otherwise, taxpayers could avoid the rules by simply transferring their residential properties to a company.

33. However, it is an open question whether the proposal should apply to more widely held companies and, if so, to what extent. On one hand, currently the vast majority of rental properties are owned by individuals, trusts, or family (close) companies[3] so a proposal that only applied to close companies could capture the majority of residential rental properties and avoid complexity for widely held companies. It would be very difficult for a taxpayer to set up a widely held company to hold their own residential properties without significantly changing the nature of their investment. For this reason, the RLR and MUA rules both apply only to residential property held by close companies.

34. On the other hand, the principle that interest deductions should be denied for borrowing relating to residential property should arguably apply equally to all taxpayers, regardless of their legal form. Moreover, limiting the rules to close

2 Associates are treated as a single individual.

3 Based on 2019 income tax returns, less than 0.1% of entities returning any rental income were widely held companies.

companies may encourage groups of taxpayers to form widely held companies to debt-fund residential rental investment. There are recent reports in the media of this kind of activity.

35. Extending the proposal to widely held companies could increase the after-tax costs of retirement villages if they come under the broadened scope. This may be inappropriate given the objective is concerned with dampening investor demand for existing housing stock (CAB-21-MIN-0045 refers), especially when other potential buyers of the housing stock are first-home buyers. This is unlikely to apply for the residential housing stock of retirement village operators. On the other hand, retirement village operators may compete for development sites with other property developers and reducing the after-tax return to the former group may be necessary to ensure a level playing field. However, allowing interest deductions for developers and purchasers of new builds will mitigate this in most cases. We note that even if the proposal were extended to widely held companies (whether only land-rich ones or all widely held companies), it would still be possible to exclude retirement villages, which are currently excluded from the definition of "residential land" that applies for purposes of the bright-line test.

36. Issues around employer-provided accommodation can also arise with the bright-line test, though it is possible that these could be resolved by changing the definition of "residential land", rather than through narrowing the scope of persons affected by the interest limitation proposal.

37. There are three options for applying the interest limitation proposal to companies:

37.1 **Option A**. Apply it to close companies only.

37.2 **Option B**. Apply it to close companies and any "residential land-rich" company where residential property makes up more than a certain percentage (say, 25 per cent) of its total assets.

37.3 **Option C**. Apply it to all companies.

38. Table 2 below summarises the advantages and disadvantages of these options.

Table 2. Application of rules to widely held companies

Option	Advantages	Disadvantages	Other impacts
A. Close companies only	• Simplest and lowest compliance cost • Consistent with the mixed-use asset and residential loss ring-fencing rules	• Different tax treatment for close companies and widely held companies could be viewed as unfair	
B. Close companies and widely held companies that are "residential land-rich"	• Reduces compliance costs for widely held companies that are not "residential land-rich" • Consistent tax treatment for all residential land-rich companies	• Increases compliance costs for companies close to and over the "residential land-rich" threshold	• May increase costs for residents of retirement village
C. All companies	• Consistent, principled, approach for all taxpayers	• May increase complexity and impose compliance costs on companies that hold residential property	• May increase costs for residents of retirement villages

		incidental to their main business	

39. Officials recommend Option B (close and residential land-rich companies). However, we consider all options are viable and you may wish to consult on all three.

Next steps

40. Officials are available to discuss the contents of this report with you at the next Joint Ministers' meeting.

41. We intend to report to you after that meeting on a possible policy framework to help guide other important design decisions for the interest limitation proposal.

42. Officials will continue to discuss key design issues with you over the coming weeks as work progresses on the interest limitation proposal.

Appendix – Other interest allocation approaches

1. The other interest allocation approaches that officials have considered include:

   1.1 Stacking approach.

   1.2 Apportionment approach.

   1.3 Security approach.

2. However, we do not consider any of these approaches to be viable, given your desire to ensure that interest deductions on loans to fund small businesses remain unaffected.

Stacking approach

3. The stacking approach looks at all of a taxpayer's debt (and also sometimes their associates' debt) and allocates it to assets according to a prescribed order at the end of each income year.[4] The prescribed order would depend on how strongly you wish to incentive or disincentivise certain purchases. This is shown in **Example 2**.

Example 2 – Stacking approach

Property Ltd has debt of $700,000 and owns the following assets, with a total value of $1.8m:

- residential rental property acquired before application date, valued at $300,000
- residential rental property acquired after application date, valued at $500,000
- assets used in a small restaurant business, valued at $1m.

Harsh stacking

Assume the prescribed stacking order is: (1) post-application date rental property; (2) pre-application date rental property; (3) non-residential business assets.

Property Ltd's debt would first be allocated to the post-application date property so $500,000 would be subject to full interest denial. The remaining $200,000 of debt would be allocated to the pre-application date rental property, so would be subject to phasing.

Even if Property Ltd takes out a further loan to buy more equipment for the restaurant business, interest on the first $100,000 of that loan will be allocated to the pre-application date rental property and subject to phasing. Any part of the loan beyond $100,000 will be allocated to the restaurant assets and interest will be deductible on that part.

Generous stacking

Assume now that the prescribed stacking order is: (1) non-residential business assets; (2) pre-application date rental property; (3) post-application date rental property.

Property Ltd's debt would be allocated entirely to the restaurant assets so interest would be fully deductible. If Property Ltd took out more debt to buy a third residential rental property, interest deductions would be fully allowed on a further $300,000 of debt (as that debt would still be allocated to the restaurant assets). Beyond $300,00 of debt, interest deductions will be subject to phasing or full denial.

4. As Example 2 illustrates, a harsh stacking approach would have the effect of denying interest deductions on some loans used for small business purposes. The principle of stacking is that money is fungible, and debt in reality funds all of the borrower's assets. This is the approach used in the existing mixed-use asset rules. On the

[4] Where loans have different interest rates, a blended/average interest rate is used.

other hand, a generous stacking approach would allow taxpayers to easily borrow to acquire residential rental properties without losing any interest deductions.

Apportionment approach

5. An apportionment approach looks at a taxpayer's balance sheet and allocates the debt in proportion to their assets.

Example 3 – Apportionment approach

Assume Property Ltd has the same debt and assets as in Example 2.

Applying an apportionment approach:

- 27.8% (500k/1.8m) of the debt would be allocated to the pre-application date rental property,

- 16.7% (300k/1.8m) of the debt would be allocated to the post-application date rental property, and

- 55.6% (1m/1.8m) of the debt would be allocated to the restaurant assets.

6. As Example 3 illustrates, an apportionment approach would have the effect of partially denying interest deductions on loans used for small business purposes (for taxpayers that own both business and residential property assets). Apportionment also involves high compliance costs as it depends heavily on asset valuations. It is the approach that applies, for example, to New Zealand subsidiaries of multinational groups, to prevent them over-allocating interest expense to their New Zealand activities.

Security approach

7. A security approach would deny interest deductions on any debt secured against a residential rental property.

8. Officials do not consider a security approach is viable. Mortgage agreements often provide that any security given by the borrower secures any loans the borrower has with the particular bank, as well as any future loans the borrower may have with the same bank. It will not therefore be possible to link a loan with any particular property. Furthermore, the fact that an asset is given as security for a loan often has little to do with the purpose for which the loan is used.

POLICY AND REGULATORY STEWARDSHIP

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

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

Action sought

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

Contact for telephone discussion (if required)

Name	Position	Telephone
Chris Gillion	Policy Lead, Inland Revenue	s 9(2)(a)
Shanae Sherriff	Senior Policy Advisor	

27 April 2021

Minister of Finance
Minister of Revenue

Interest limitation proposal – further scope and design issues

Executive summary

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

The key decisions covered in this report are:

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

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

Recommended action

We recommend that you:

Rest homes and retirement villages

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

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

   Agreed/Not agreed Agreed/Not agreed

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

   Agreed/Not agreed Agreed/Not agreed

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

Agreed/Not agreed Agreed/Not agreed

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

Referred/Not referred Referred/Not referred

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

Agreed/Not agreed Agreed/Not agreed

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

Agreed/Not agreed Agreed/Not agreed

Income-earning use of a main home

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

5.1 Owner-occupiers with flatmates;

5.2 Owner-occupiers with boarders;

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

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

Agreed/Not agreed Agreed/Not agreed

New builds purchased off the plans prior to 27 March

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

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

Agreed/Not agreed Agreed/Not agreed

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

Agreed/Not agreed Agreed/Not agreed

Application to non-close companies

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

7.1 *Option A:* Close companies only;

Agreed/Not agreed Agreed/Not agreed

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

Agreed/Not agreed Agreed/Not agreed

7.3 *Option C:* All companies;

Agreed/Not agreed Agreed/Not agreed

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

Agreed/Not agreed Agreed/Not agreed

Treatment of denied interest when property is sold

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

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

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

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

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

Agreed/Not agreed Agreed/Not agreed

Interaction with residential loss ring-fencing rules

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

Agreed/Not agreed Agreed/Not agreed

Foreign property loans

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

    13.1 The proposals should not apply; OR

    Agreed/Not agreed Agreed/Not agreed

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

    Agreed/Not agreed Agreed/Not agreed

s 9(2)(a)

Chris Gillion
Policy Lead
Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2021

Hon David Parker
Minister of Revenue
/ /2021

Purpose

1. This report sets out options for public consultation on how to treat denied interest when a property is sold. It also seeks decisions from Ministers on certain scope and design issues.

2. Where applicable, officials intend to put forward proposed approaches on the topics covered below in a consultation document and invite submissions on the details of how those approaches will be applied.

Background

3. On 8 March 2021, Cabinet agreed in principle to limit deductions for interest incurred on residential investment property (CAB-21-MIN-0045 refers). Cabinet also directed officials to consult with stakeholders on the design details of the interest limitation proposal before seeking final decisions from Cabinet.

4. Given the timeframes involved, it would be useful to get some further design decisions agreed and thereby reduce the number of issues being publicly consulted on. Refining the scope of the consultation document in this way would allow officials to concentrate their efforts on relevant second-order decisions and can help focus submissions on areas where consultation is likely to be most helpful. Early decisions on these issues will also reduce complexity and increase certainty for taxpayers.

Rest homes and retirement villages

5. This section seeks Ministerial direction on the treatment of rest homes and retirement villages. There are arguments both for and against including them in the scope of the proposed interest limitation rules and we seek your direction on how this topic should be broached in the upcoming discussion document.

6. Officials' starting position is that the definition of residential land used for the bright-line test would form the basis for property subject to the proposed interest limitation rules. At its simplest, residential land is defined as land with a dwelling on it. For the purposes of the bright-line test, a dwelling is a place that is configured as a residence or abode, whether or not it is used as such. Certain commercial structures are specifically excluded from the definition of dwelling, including hospitals, nursing homes, hospices, hotels, and motels.

7. Under the bright-line test, rest homes and retirement villages are also specifically excluded. The rationale is that these properties are not "flipped" in the same way that regular houses and apartments can be, even though in many cases they do resemble standard residential properties and are intended to be used as long-term accommodation. They are regulated and there are rules regarding who may occupy a unit. The occupant has little or no opportunity to assign rights to someone else, which minimises the risk of shorter-term speculative investment.

8. If rest homes and retirement villages were not explicitly excluded from the bright-line test, we anticipate that most residents would qualify for the main home exclusion anyway. The specific carveout therefore removes any potential uncertainty, reduces compliance costs, and provides peace of mind.

9. The relevant considerations for the proposed interest limitation rules may be slightly different. The Government's purpose for introducing the new interest limitation rule is to support more sustainable house prices and improve affordability for first home buyers by dampening investor demand for existing property.

10. Given this intention, it may be unnecessary to apply the proposed interest limitation rules to retirement villages and rest homes. While dwellings in retirement villages

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

11. In addition, if retirement villages and rest homes are subject to the interest limitation rules, the operators of rest homes and retirement villages may pass the increased tax burden onto individual residents. Increasing costs for rest home and retirement village residents may be contrary to Cabinet's objective of ensuring that every New Zealander has a safe, warm, dry, and **affordable** home. While the interest limitation proposal may increase costs for renters generally, this is less justified for retirement village residents as doing so is unlikely to meet the objective of supporting more sustainable house prices and improving affordability for first home buyers.

12. If the increased costs from applying the interest limitation rules are passed on to individual residents, this could also reduce the effectiveness of the measure for supporting more sustainable house prices and improving affordability for first home buyers. Currently there may be an under-utilisation of existing housing by retirees, particularly in urban centres. This could occur because a property has been the family home for several years and the owner may be reluctant to move out even once their children have moved out. If the cost of a unit in a retirement village were to increase, this could add another barrier to downsizing. It may also increase the minimum price the owner would be willing to accept. This is an important consideration as it could impact the ability of first home buyers to enter the housing market.

13. While applying the new interest deductibility rules to retirement villages and rest homes is unlikely to directly support the Government's housing objectives, there may be other reasons why you would want to apply the new interest limitation rules to retirement villages and rest homes.

14. An exemption could be seen as providing a tax advantage to operators of retirement villages and rest homes versus providers of rental accommodation. This may be perceived as unfair, given media attention regarding the profitability and tax-paying profile of certain retirement village operators (for example, in the context of the wage subsidy).

15. If they would otherwise pass the increased tax burden onto individual residents if no specific carveout were provided, an exemption for retirement villages could also be seen as a subsidy specifically for retirees who have the financial resources to move into a retirement village. This could raise equity concerns as it disadvantages older people who do not have the financial means to move into a retirement village and must remain in private rental accommodation. This equity concern about access is not as relevant for rest homes, as the residential care subsidy is available.

16. If Ministers decide to apply the new interest limitation rules to retirement villages, you may also wish to consider treating rest homes differently from retirement villages. We consider that a distinction could be drawn between rest homes and retirement villages. Rest homes may be more akin to a nursing home, in that additional medical and assisted-living services are provided as residents are less independent than those in retirement villages more generally. Retirement villages are more like residential rental accommodation exclusively for older people (although often requiring a lump sum payment at the outset for a license to occupy, rather than ongoing rental payments).

17. Some providers will operate a combination of the two services on one site, with residents moving between a village setting and a hospital care situation more akin to a rest home as their situation dictates. Treating the two types of accommodation differently may thus lead to boundary issues or increased compliance costs.

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

18. We seek your direction on whether rest homes and/or retirement villages should be outside the scope of the proposed interest limitation rules, or specifically included.

19. Te Tūāpapa Kura Kāinga – Ministry of Housing and Urban Development recommends that rest homes and retirement villages be outside the scope of the proposed interest limitation rules. This is because applying these rules to retirement villages and rest homes would not support the Government's housing market objectives.

Income-earning use of the main home

20. We also seek your direction on whether income-earning use of a main home should be exempt from the interest limitation proposal. In the absence of such an exemption, the rules would apply to owner-occupiers who have flatmates or boarders, provide short-stay accommodation in their main home or who use their home for some other income-earning use (for example, a home office). Currently these owner-occupiers can deduct a portion of their interest for the loan used to acquire their home.

21. The Government's press release stated that the interest deductibility rules would not affect the family home. This statement could be interpreted as saying the rules would not affect the family home as interest on the family home is generally not deductible currently (as there is no nexus with income). Alternatively, it could be interpreted as saying that any currently deductible interest on the family home will remain deductible under the new rules.

22. Not exempting main homes used for income-earning purposes could disincentivise homeowners from providing accommodation in their main home, which could place further pressure on the rental housing market. Applying the interest limitation rules to these scenarios may also have a negative effect on some first home buyers, as it is not uncommon for first home buyers to get flatmates in to help with repaying their mortgages. Providing a main home exemption would also avoid potentially worsening the existing under-utilisation of owner-occupied housing.

23. Owner-occupiers that derive rental income from having flatmates are presently required to apportion their expenses such as mortgage interest, rates and insurance between private and income-earning use based on a floor area calculation. There is tax to pay if the rental income from flatmates exceeds the total expenses attributed to income-earning use.

24. Boarders are different to flatmates. When boarders rent rooms in a house, part of the rent they pay is for services provided such as meals and laundry. A common example of a boarding situation is a home-stay student staying with a host family in their private home.

25. Officials note that not providing a main home exemption from the interest limitation proposal could be especially problematic for some owner-occupiers who have boarders.

26. An Inland Revenue determination sets out the standard cost of providing private boarding services which may be used by taxpayers instead of their actual expenses if they have four or fewer boarders. If their boarding income is equal to or less than the standard cost, the taxpayer is not required to pay tax on their boarding income.

27. If interest deductions will no longer be available to those providing private boarding services, the determination will need to be significantly revised and may need to be removed entirely, as mortgage interest is likely to make up the largest part of the

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

28. Limiting interest deductions for owner-occupiers with boarders may also affect those on low incomes. Anecdotally, Work and Income sometimes advises beneficiaries to get boarders as a means of helping to cover living costs.

29. All or part of a residential property that is a person's main home may sometimes be rented out as short-stay accommodation. While the use of a main home to provide accommodation to a flatmate or boarder would have the most beneficial impact on the housing market, the same arguments regarding supporting first home buyers to meet their mortgage repayments are also applicable other income-earning uses (such as short-stay accommodation or home offices). Exempting short-stay accommodation provided in a taxpayer's main home from the scope of the proposal would also avoid creating a boundary between flatmates and short-stay accommodation guests.

30. Officials recommend that there be a main home exemption from the interest limitation rules for all income-earning uses of a main home. The Ministry of Housing and Urban Development agrees with this recommendation.

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

31. Cabinet agreed in-principle that the new build exemption would apply to property purchased in New Zealand on or after 27 March 2021, and within 12 months of receiving its code compliance certificate (CCC) (CAB-21-MIN-0045 refers). For a property purchased off the plans, the new build exemption would not apply where the property receives its CCC in (for example) January 2022 if the agreement to purchase the property was entered into before 27 March 2021. Interest deductions for the property would be phased out at a rate of 25% over four years. On the other hand, interest would be deductible if the same property was purchased on or after 27 March 2021, and within 12 months of CCC being issued.

32. Officials seek your agreement to consult on a proposal that a property purchased off the plans would qualify for the new build exemption provided the property receives its CCC on or after 27 March, even if the property is purchased before this date. This is a transitional issue that only affects new builds purchased off the plans before 27 March that receive their CCCs after this date. There are a number of reasons why officials consider this the preferred option for inclusion in the consultation document.

33. First, applying the exemption to these properties may help prevent a reduction in new housing supply. While the exemption may not necessarily be required to increase housing supply because investors will have decided to purchase these properties before 27 March, in the absence of allowing the exemption to apply some investors may decide to cancel agreements to purchase these properties where they are able to.

34. Second, it would simplify the rules by making the date an interest in these properties is first acquired irrelevant to whether the new build exemption applies. Instead, the relevant question would generally be whether a CCC for a property

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

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

36. Officials therefore recommend the consultation document propose that the new build exemption should apply to properties purchased off the plans that are completed and receive their CCCs on or after 27 March, regardless of when agreements to purchase such properties are entered into.

Application to non-close companies

37. In IR2021/133, T2021/847, officials considered the extent to which the interest limitation proposal should apply to companies. The report set out three scope options for companies:

37.1 **Option A**. Apply it to close companies only.

37.2 **Option B**. Apply it to close companies and any "residential land-rich" company where residential property makes up more than a certain percentage (say, 25 per cent) of its total assets.

37.3 **Option C**. Apply it to all companies.

38. The Minister of Revenue has requested more advice on whether Option B would sufficiently limit opportunities to avoid the interest limitation rules by putting residential properties in non-close companies. Officials consider that Option B would be sufficient.

Definition of "close company"

39. A "close company" is a company where five or fewer natural persons or trustees directly or indirectly hold more than 50% of the company.[2] As the "close company" definition looks through interposed corporate shareholders to natural persons and trustees,[3] a person cannot avoid having a "close company" by splitting the share ownership among other companies that they control.

40. The "close company" definition also treats natural persons who are associated as a single person. Relatives are treated as associated if they are within two degrees of blood relationship, or in a marriage, civil union or de facto relationship, or within two degrees of blood relationship to the person's spouse, civil union or de facto partner. A person could not, therefore, get around the "close company" definition

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

[2] Measured by voting interest or market value.

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

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

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

Reasons for applying the rules beyond close companies

42. The reason officials recommended going further and applying the interest limitation proposal to residential land-rich companies (Option B) is that otherwise, groups of (unrelated) taxpayers may be incentivised to form widely-held companies to debt-fund residential rental investment. This may give rise to fairness issues as well as limit the impact of the proposal on house prices.

43. Officials did not recommend applying the proposal to all companies (Option C) because tracing is difficult for businesses that have many sources of funds and a variety of different assets. If businesses hold relatively small amounts of residential land, they would be able to obtain full deductibility of interest under the tracing approach anyway by ensuring all borrowing is used to fund non-residential assets. Option C could therefore impose large compliance costs for companies while raising minimal revenue (compared to Option B). This is the reason the current tax law generally does not require companies to trace interest expenses; interest is deductible to companies unless an exclusion applies. Moreover, the additional companies Option C would capture (compared to Option B) are unlikely to contribute significantly to high house prices as their core business would not involve owning residential land.

44. For the reasons above, officials recommended Option B (close companies and residential land-rich companies, with the land-rich threshold determined after consultation).

Treatment of denied interest when property is sold

45. Under the interest limitation proposal, the general treatment will be that no deduction will be allowed for interest on debt that funds investment in residential investment property. This will not apply to interest on debt that funds property development and the purchase of new builds. The discussion document will discuss details of how to implement these policies.

46. Cabinet decided that "officials consult on whether interest deductions should be denied or merely deferred if the taxpayer is not a property developer but is taxed on the disposal of their property under the bright-line test or another land sale rule" (CAB-21-MIN-0045 refers).

47. This section sets out a set of options that officials propose to include in the discussion document to discuss the deductibility of interest in situations where property will only be taxed if sold within the bright-line period and is not covered by the new build (or any other) exemption from interest limitation.

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

Option 1: Permanent non-deductibility

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

Option 2: Deductibility if sale of property is taxable

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

Option 2 timing of deduction

51. If this option is adopted, it would not be appropriate to allow the deduction for interest to be taken in the year when the interest is paid. Because the taxation of sale proceeds under the bright-line test is uncertain until either the property is sold or the bright-line period expires, it makes sense to:

51.1 deny a deduction for interest when it is paid; and

51.2 then allow it only if the sale is in fact taxable.

52. Also arguing in favour of deferring interest deductions is the fact that the income from the increase in the property's value is only taxable when the property is sold – not as the property changes in value.

Option 2 loss limitation

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

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

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

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

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

56. Another way of thinking about this option is to treat it as apportioning the interest expense. Interest is first allocated to the sale of property, up to the amount of any gain on sale, and deductible to that extent only if the sale is taxable. Any remaining interest expense is allocated to the cost of renting the property out and is therefore deductible.

57. A possible objection to this approach is that it is somewhat one-sided. Interest is deductible if it exceeds a tax-free gain, but the exemption from tax for capital gains means gains are not taxable if they exceed interest. If the gain on sale in the example above were $200, a deduction would be denied for the $150 of interest expense, which would leave $50 of tax-free gain which is not "countered" by non-deductible interest.

Option 3 loss limitation

58. As with option 2, if option 3 means the sale of a property results in a net loss in the year of sale ($50 in the example above) the deductibility of this loss would be limited by current law (most likely under the residential loss ring-fencing rule, which provides that residential property expenses are generally deductible only against residential property income). This limitation would continue to apply, though modifications may be consulted on.

59. Cabinet did not consider or decide the question of whether consultation should include allowing a deduction for interest in some cases when residential investment property is sold on capital account (non-taxable). Recommendation 11 authorises officials to consult on this option for non-taxable sales.

Interaction with residential loss ring-fencing rules

60. Residential rental loss ring-fencing rules were introduced in 2018 to reduce tax benefits for property investors compared to owner-occupiers. The interest limitation proposal would shift this setting further in favour of owner-occupiers by imposing higher levels of tax on leveraged property investors. The interest limitation proposal includes some exemptions to favour new supply that were not considered for residential loss ring-fencing.

61. There will be significant interplay between the interest limitation rules and the residential loss ring-fencing rules. We think the most logical approach is to have the interest limitation rules determine if interest is potentially deductible in an income year. If it is deductible under the interest rules, the timing of the deduction may be deferred under the residential loss ring-fencing rules (if the taxpayer has

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

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

Foreign property purchased using foreign currency loans

63. One area where officials have received a number of queries, and where we seek your direction, is how, if at all, these proposals might apply to foreign currency loans.

64. For the purpose of this report, we are seeking your guidance on loans denominated in a foreign currency used to fund a residential rental property that is situated outside New Zealand.[5]

65. Foreign currency loans will most commonly arise in two situations:

    65.1 Migrants to New Zealand who hold and rent out foreign properties acquired before migrating to New Zealand; and

    65.2 New Zealand residents who own a foreign property as a holiday home but rent it out while they are not using it to cover part of the cost. These will be taxed under the mixed-use asset rules.

66. Some New Zealand residents may also own foreign rental properties as an investment but we expect there will be less of these than the other two situations as an equivalent investment in New Zealand rental property will be logistically easier for most New Zealanders to manage.

67. Currently, if these properties are owned by a New Zealand tax resident, expenditure on these loans will be deductible and calculated under the financial arrangements rules. This calculation will include both the New Zealand dollar equivalent of interest expenditure as well as any foreign exchange gains or losses on the principal.

68. There is more complexity in calculating interest deductions on a foreign currency loan than an equivalent New Zealand dollar loan and this would be magnified if the interest limitation proposal applies to foreign currency loans. Limiting interest deductions on foreign currency loans is likely to raise a number of issues, unintended consequences, and — depending on the method chosen — the potential for relatively large assessable income or deductions on unrealised gains and losses. Officials do not consider there is sufficient time to develop transitional proposals in time for inclusion in the discussion document to be provided to you in May, and that any transitional proposals would need to be subject to consultation due to the risks outlined above.

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

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

69. One of the Government's overarching policy objectives is to "support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first home buyers". While not explicit, we assume this objective is to dampen investor demand for New Zealand housing stock to improve affordability for first home buyers of New Zealand houses. Limiting interest deductions on foreign properties will have no direct effect on the price of New Zealand houses.

70. Officials' preference is to exclude foreign currency denominated loans for foreign residential rental properties from the interest limitation proposal for the following reasons:

    70.1 This would be consistent with the intent of the interest limitation proposal to reduce investor demand for New Zealand housing.

    70.2 This would prevent discouraging skilled migrants that meet all relevant immigration criteria but own property in their home jurisdiction.

    70.3 This would reduce the complexity of the interest limitation rules and free up resources towards developing other aspects of the proposal.

    70.4 To the extent excluding these loans encourages investment in foreign rental properties, it may further reduce investor demand for existing New Zealand housing stock. However, due to the simpler logistics, officials consider most investors are likely to prefer a New Zealand new build over a foreign property despite similar tax treatment.

71. Alternatively, if you want to limit interest deductions for foreign currency denominated loans for foreign residential rental properties, we recommend this limitation applies only to properties acquired on or after 27 March 2021. This would more closely align the treatment of foreign loans with loans for New Zealand properties. As no transitional adjustments would be required it is only slightly more complex than a complete exclusion.

Consultation

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

Next steps

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

Inland Revenue
Te Tari Taake

POLICY AND REGULATORY STEWARDSHIP

TE TAI ŌHANGA
THE TREASURY

Tax policy report: Discussion document – Design of the interest limitation rules and additional bright-line rules

Date:	27 May 2021	**Priority:**	High
Security level:	In Confidence	**Report number:**	IR2021/231 T2021/1377

Action sought

	Action sought	Deadline
Minister of Finance	**Authorise** the lodgement of the attached Cabinet paper	10am Thursday 3 June 2021
Minister of Revenue	**Authorise** the lodgement of the attached Cabinet paper **Refer** report to the Minister of Housing and Associate Ministers of Housing (Public Housing and Māori Housing)	10am Thursday 3 June 2021

Contact for telephone discussion (if required)

Name	Position	Telephone
Felicity Barker	Team Leader, The Treasury	s 9(2)(a)
Chris Gillion	Policy Lead, Inland Revenue	

27 May 2021

Minister of Finance
Minister of Revenue

Interest limitation discussion document

Executive summary

Purpose

This report attaches the draft discussion document and Cabinet paper on the proposed interest limitation rules and on additional changes to the bright-line rules for your consideration. It also provides a summary of the proposals contained in the discussion document, including issues that Ministers ought to be aware of, and sets out next steps.

Context and background

On 8 March 2021, Cabinet agreed in principle to limit deductions for interest incurred on residential investment property and to exempt new builds from both the proposed interest limitation rules and the extended bright-line test (CAB-21-MIN-0045 refers). Cabinet also directed officials to consult with stakeholders on the design details of the interest limitation proposal before seeking final decisions from Cabinet.

The proposals in the attached draft discussion document are the product of consultation with private sector stakeholders via an External Reference Group (ERG) and collaboration with the Ministry of Housing and Urban Development (HUD). Although no further substantive changes to the document are being made, it continues to be fine-tuned and edited.

Decisions with major impacts on the Government's goal

Design of the interest limitation rules is complex. While the discussion document covers a lot of complexity, some key features of the proposal will impact on the extent to which the proposals impact on the Government's goal to reduce investor demand and support first home buyers, and to support housing supply in the long term. Some of the key design features and their impacts are:

- **The treatment of interest on disposal:** The discussion document presents various options as to how interest would be treated on disposal of the property. This ranges from interest always being denied, to interest being fully allowed if gains on sale are taxable. Full denial of interest, whether or not gains are taxable on sale, would increase the expected effective tax rate on leveraged investment properties the most and therefore discourage debt-financed investor activity the most. Allowing interest to be deducted on disposal where capital gains are taxable would seek to align the system more with income tax principles, by allowing expenses to be recognised when income is fully taxed.
- **The length of the new build exemption and whether it can be passed on:** A longer new build exemption, and more generous rules in regards to passing on the exemption, will result in the policy having less impact on house prices than a shorter

exemption. However, since longer exemptions have less impact on house prices, it follows that longer exemptions and allowing the exemption to be passed on to subsequent buyers could have less negative impact on housing supply than shorter exemptions.

- **Earning income from a main home:** This allows owner-occupiers who rent out part of their home to deduct interest against that income. This will support first home buyers by making entering the housing market more affordable for them.

Next steps

The discussion document is planned for release in early June after consideration by Cabinet on Tuesday 8 June. Cabinet will consider the final policy design on 27 September, and the legislation in the form of a Supplementary Order Paper is planned to be released before 1 October.

Recommended action

We recommend that you:

1. **authorise** the attached Cabinet paper and discussion document for lodgement with the Cabinet Office;

   Authorised Authorised

2. **refer** a copy of this report to the Minister of Housing, the Associate Minister of Housing (Public Housing), and the Associate Minister of Housing (Māori Housing) for their information.

   Referred/Not referred

s 9(2)(a)

Felicity Barker	**Chris Gillion**
Team Leader	Policy Lead
The Treasury	Inland Revenue

Hon Grant Robertson	**Hon David Parker**
Minister of Finance	Minister of Revenue
/ /2021	/ /2021

Purpose

1. This report attaches the draft discussion document and Cabinet paper on the proposed interest limitation rules and on additional changes to the bright-line rules for your consideration. It also provides a summary of the proposals contained in the discussion document, including issues that Ministers ought to be aware of, and sets out next steps.

Context and background

2. On 8 March 2021, Cabinet agreed in principle to limit deductions for interest incurred on residential investment property and to exempt new builds from both the proposed interest limitation rules and the extended bright-line test (CAB-21-MIN-0045 refers). Cabinet also directed officials to consult with stakeholders on the design details of the interest limitation proposal before seeking final decisions from Cabinet.

3. The proposals in the attached draft discussion document are the product of consultation with private sector stakeholders via an External Reference Group (ERG) and collaboration with the Ministry of Housing and Urban Development (HUD). Consultation with the ERG has been especially valuable in refining the proposals included in the discussion document.

4. The aim is to release the discussion document in early June after consideration by Cabinet on Tuesday 8 June. Cabinet will consider the final policy design on 27 September. The legislation in the form of a Supplementary Order Paper is planned to be released before 1 October.

5. There is significant complexity in the proposals in the discussion document, which is largely unavoidable. The discussion document contains a lot of detail about how the proposed rules could apply. This should provide more certainty to those affected by the proposals. Some aspects of the rules are complex but this is necessary given the exemptions for property development and new build properties, and the need to ensure that taxpayers cannot get around the rules by holding residential property in entities.

6. Officials are in the process of finalising the discussion document, so the document is still subject to minor editorial changes.

7. The proposals in the discussion document are summarised below. The following section also notes aspects of the proposals that Ministers should be aware of, including some potentially contentious aspects.

Proposals in the discussion document

Scope and general application of the rules

Residential property subject to the rules (chapter 2)

8. Chapter 2 outlines the intended scope of the proposed interest limitation rules. In general, the intent is that the scope of property affected by interest limitation should align as much as possible with the pre-existing definitions of "residential land" and "dwelling" in the Income Tax Act 2007 used for the purposes of the bright-line test and the residential ring-fencing rules.

9. This broadly means the proposed rules would apply to property in use as long-term residential accommodation (such as residential rental property covered by the

Residential Tenancies Act 1986) or property that is easily substitutable for long-term residential accommodation (such as homes converted into short-stay accommodation advertised predominantly on digital platforms). At the simplest level, this should include a house or apartment, regardless of whether it is used to provide long-term or short-term accommodation.

10. The chapter suggests specific exclusions from the interest limitation proposal for the following property types:

10.1 **Employee accommodation:** Businesses provide employee accommodation for a number of reasons, including where the employment location is remote or working hours are highly variable (for example, shift work). Employee accommodation is not generally substitutable for owner-occupied housing and would not compete with regular residential property, placing it outside the scope of the Government's objectives. On this basis the draft discussion document proposes a carveout for all employee accommodation (with satisfactory integrity measures to minimise the potential for abuse).

10.2 **Land outside New Zealand:** In accordance with a decision taken by Ministers, the draft discussion document proposes to exclude foreign properties from the interest limitation rules, regardless of whether the mortgage is denominated in New Zealand dollars or a foreign currency (IR2021/181 refers).

10.3 **Farmland:** The definition of "residential land" used in the bright-line test specifically excludes farmland. The draft discussion document proposes adopting this exclusion for the interest limitation rules. This would mean that farmland would not be subject to the rules, even if there is a dwelling on the land that is used to provide accommodation (whether to employees or a third party).

10.4 **Care facilities:** For instance, hospitals, convalescent homes, nursing homes, and hospices, where accommodation is incidental to the provision of care services, and is easy to distinguish from housing typically available as a private residence for owner occupiers.

10.5 **Commercial accommodation:** There are specific types of short-term commercial accommodation that are generally relatively easy to distinguish from properties that are suitable for owner-occupation: for instance, hotels, motels, inns, hostels, boarding houses and camping grounds. Some of these facilities can be used to provide long-term accommodation (for example, emergency accommodation), but they do not generally compete with owner-occupied housing.

10.6 **Retirement villages and rest homes:** Ministers previously decided that rest homes and retirement villages should be specifically excluded from the scope of the interest limitation proposal (IR2021/181 refers).

10.7 **Main home:** Ministers previously decided that the interest limitation proposal would not apply to interest related to any income-earning use of an owner-occupier's main home (IR2021/181 refers). This will support housing affordability for first home buyers as well as encourage greater utilisation of housing.

11. The chapter also considers possible exclusions for certain student accommodation, serviced apartments, and Māori land, and raises how the rules might apply to dual-purpose buildings as another issue for further discussion. These issues are outlined below.

Student accommodation

12. Student accommodation (for example, halls of residence) does not compete with owner-occupied accommodation and would not typically be set up in a way that would be conducive to private owner occupation. In many situations, a specific carveout for student accommodation may not be required. However, further certainty could be provided by carving out specific types of student accommodation, such as that covered by either section 5(1)(h) or section 5B of the Residential Tenancies Act 1986.

Serviced apartments

13. Serviced apartments are apartments provided for long or short-term accommodation, with amenities provided for use. In some situations, a serviced apartment may be more akin to a hotel, but in others, the physical structure may mean that it is more like a standard residential apartment building. Unlike hotels, it is not straightforward to distinguish them from properties typically suitable for owner occupation.

14. A carveout allowing owners of serviced apartments to claim interest deductions may lead to the conversion of regular apartments into serviced apartments, which would reduce effective housing supply. However, the chapter acknowledges that a carveout for serviced apartments that more closely resemble hotels might be warranted and seeks submissions on how such a carveout might be designed to prevent standard residential apartments from being converted into serviced apartments.

Māori land and housing

15. Papakāinga and kaumātua housing have different features that may distinguish them from properties easily substitutable for owner-occupation. These may provide reasons to exclude them from the scope of the interest limitation rules. However, there are definitional issues around papakāinga and kaumātua housing, as these are not defined in legislation and some differences exist between the way in which Te Puni Kōkiri (TPK) thinks of papakāinga housing and the way in which it is more widely understood in tikanga Māori. Note that Māori entities also provide rental housing on general title land to the general public and in this case they could be treated like any other landlord on the general rental market.

16. Additionally, there are numerous permutations of how such housing is provided, including the type of legal title, ownership structures, and purposes, which create significant complexity. We are working with TPK to develop a clearer picture of the landscape of Māori housing and the most common ownership scenarios. Given the complexities, the discussion document is intended to facilitate a discussion of the relevant issues being faced, rather than to provide a concrete proposal.

Business premises and dual-purpose buildings

17. The bright-line test definition of residential land contains a carve-out for land that is predominantly used as business premises, which operates on an all-or-nothing basis: if more than 50 percent of a given property is used as business premises, it is fully excluded; if 50 percent or less is used as business premises, it is fully included. This test is deliberately simple to reduce complexity for the bright-line test, but in the context of interest limitation it may lead to harsh outcomes where interest deductions on a given property are wholly denied or wholly allowed on the basis of a few square metres or a few days.

18. The discussion document seeks feedback on whether an apportionment approach could be used for interest limitation. This proposal was of significant interest to the ERG, and it is likely to be addressed in a number of submissions.

Short-stay accommodation

19. Another potentially contentious issue is the proposed application of the interest limitation rules to short-stay accommodation. As mentioned above, the discussion document proposes (in line with the treatment under the bright-line test) to include short-stay accommodation in what would otherwise be residential houses in the scope of interest limitation, while excluding commercial accommodation like hotels (again in line with the existing rules). While this is not a departure from the present rules, it might be controversial to draw a distinction between these two different forms of short-term accommodation. However, it is important to include short-stay accommodation provided in a dwelling as it ensures there is no income tax advantage for providing short-stay accommodation versus long-term rental accommodation.

Entities affected by interest limitation (chapter 3)

Companies

20. Companies are generally allowed deductions for interest incurred, without needing to trace the use of their borrowed funds. This chapter proposes to override that general rule for close companies and residential property-rich companies so that taxpayers cannot get around the interest limitation proposal by using companies to borrow to acquire residential properties. The chapter proposes that residential property-rich companies would be those for which residential property makes up more than 50 per cent of the value of their total assets.

Kāinga Ora and other organisations

21. Kāinga Ora provides social housing but, unlike some other social housing providers, is not a charity or registered community housing provider. It therefore cannot use existing tax exemptions that are available to charities and registered community housing providers. The discussion document proposes to exclude Kāinga Ora and its wholly-owned subsidiaries from the application of the interest limitation rules.

22. It is not proposed that any other organisations will be excluded from the interest limitation rules but submissions are sought on this.

Interest subject to limitation (chapter 4)

23. Chapter 4 proposes that a tracing approach will generally be followed for the purposes of the interest limitation rules. This was previously agreed by Ministers (IR2021/133, T2021/847 refers). To work out if interest on a loan is subject to limitation, the taxpayer must trace the use of the borrowed funds. Under the proposed rules, if a taxpayer uses a loan for purposes relating to residential property (for example, to acquire the property or pay rates and insurance for the property), interest on that loan would be subject to limitation.

Pre-effective date loans

24. In our earlier joint report (IR2021/133, T2021/847 refer), we noted there may be some instances where an approach other than tracing may be needed. One such case is for pre-effective date loans (pre-ED loans), that were drawn down and used

for more than one purpose before 27 March 2021. For example, a taxpayer may have a pre-ED loan that has been used for both residential rental and other business purposes in the past, and the taxpayer may not have the records to trace retrospectively because they previously did not need to distinguish between the two purposes (all interest was deductible).

25. The discussion document suggests two possible approaches for these situations. The first approach is apportionment, where taxpayers may apportion their pre-ED loans across their assets based on their original cost. The second approach is stacking, where pre-ED loans are "stacked" against non-residential business assets first. The stacking approach would mean that if the market value of taxpayers' non-residential business assets exceeds the value of their pre-ED loans, the taxpayer gets full interest deductibility on the pre-ED loans. While this may appear quite generous, well-advised taxpayers would usually be able to achieve the same result by restructuring their affairs under tracing anyway (and it is likely to be very difficult and costly to challenge this as tax avoidance). The stacking approach has been proposed as it would avoid restructuring costs and allow less well-advised taxpayers to achieve the same tax outcomes as well-advised ones. This is also only a transitional issue.

High water mark proposal

26. Another in-principle decision taken by Cabinet was that further borrowing on or after 27 March 2021 that relates to residential properties acquired (or treated as acquired) before that date will not result in deductible interest (CAB-21-MIN-0045 refers).

27. If a borrower has a variable balance loan, such as a revolving credit facility, technically each withdrawal is new borrowing even though, over time, the balance may remain relatively constant or decline. Tracing each transaction from such an account would incur high compliance costs relative to the amount of each transaction and could incentivise inefficient behaviour. For example, taxpayers may defer principal repayments that would have otherwise been made so that money is available to spend at a later date without being new borrowing.

28. The discussion document proposes a concession to allow a borrower to make withdrawals that were traced to a pre-ED residential property without interest on that borrowing becoming immediately non-deductible, but only up to the loan balance set on 26 March 2021 (or a later date when the property is treated as acquired by that date). This is referred to in the document as the high water mark proposal. This concession will reduce compliance costs, prevent tax influencing financing decisions and will have no impact on tax deductions after the expiry of the transitional phasing period.

Disposals of property subject to interest limitation (chapter 5)

29. A question that arises concerns whether interest expense that was previously disallowed under the interest limitation rules should be deductible at the time of sale of the property. This area is the one that is most open for major policy decisions that could have a large impact on the final tax position of a rental property investor, so it is likely to attract many submissions.

30. There are a number of dimensions to this:

30.1 **Taxable (revenue account) sales:** As all income is taxed, there is an argument that all expenses should be deductible. Cabinet recommended that officials consult on the treatment of denied interest deductions in the case of residential investment property that was held on revenue account (that is, taxable on sale) (CAB-21-MIN-0045 refers).

30.2 **Non-taxable (capital account) sales:** The capital gain on sale is not taxed, so arguably interest expense should not be deductible. However, there is an argument for deducting interest to the extent it exceeds any non-taxable capital gain. Ministers have indicated that officials may consult on whether some portion of interest may be deducted on capital account sales where appropriate.

30.3 **Gaming opportunities:** Having different rules for allowing deductions on revenue account and capital account may create opportunities to choose different treatments for different tax results.

31. The greater the extent to which an interest deduction is allowed on sale, the more an initial disallowance of the deduction is converted to a deferral of the deduction, thus reducing the overall impact on the housing market but potentially increasing fairness and tax efficiency.

32. Chapter 5 discusses these issues and options to address them.

Exemptions

Property development and related activities (chapter 6)

33. Cabinet has agreed in principle that property developers should be provided an exemption from the interest limitation rules (CAB-21-MIN-0045 refers). This will allow developers to continue deducting their interest expenses related to the development as they are incurred.

34. It would be desirable for the exemption to be wide in scope to encompass development activity which may result in the construction of a new build (as defined in chapter 7). Chapter 6 outlines that the exemption is intended to cover:

34.1 land being developed by persons in the business of developing or dealing land, or erecting buildings (captured under section CB 7 of the Income Tax Act 2007); and

34.2 other developments which may not be covered under section CB 7, for example, persons undertaking a one-off development or developing properties to rent themselves (if not already in the business of developing or dealing in land or erecting buildings).

Remediation

35. The chapter proposes that some remediation qualify for the development exemption.

36. Remediation work can take many forms and is therefore an area where it may be difficult to create clear boundaries on whether it should qualify for the development exemption. Remediation work may extend the life of older buildings or simply make a building habitable. On the other hand, those who engage in one-off renovations which do not extend the life of the building (for example, improving a kitchen or bathroom) should not be able to claim the development exemption. Excluding remediation entirely may adversely affect heritage buildings, disincentivising their restoration. This may give rise to boundary issues between what is and what is not qualifying remediation work.

New builds (chapters 7 to 9)

What is a new build? (chapter 7)

37. Cabinet has agreed in principle that a new build is exempt from the proposed interest limitation rules and that a five-year bright-line test will apply instead of the extended 10-year bright-line test (CAB-21-MIN-0045 refers).

38. Chapter 7 sets out the proposed definition of a "new build". It proposes that a property should only qualify as a new build where a self-contained dwelling (with its own kitchen and bathroom) has been added to residential land and the dwelling has received a code compliance certificate (CCC). The chapter refers to three categories of new builds: simple new builds (where a dwelling is added to bare residential land), complex new builds (where a dwelling is added to land shared with one of more existing dwellings), and commercial to residential conversions (where a commercial building is converted into one or more dwellings).

39. It is proposed that a new build would include new dwellings as well as existing dwellings that are modified so that the number of dwellings on the land has increased. This could include where an existing dwelling is converted into multiple dwellings (for example, a six-bedroom house that is converted into three townhouses), adding a relocated house to land, and converting a commercial office block into apartments. Using existing building materials is more environmentally friendly and may increase housing stock more quickly than building completely new dwellings.

40. Where an existing dwelling is replaced with one or more new dwellings it is proposed this would qualify as a new build, even if there is no increase to the number of dwellings on the land. While one-for-one replacements may not clearly increase housing stock, it would be administratively difficult to ascertain what was on the land prior to the construction of the new build, and it could be hard to enforce a rule that excludes one-for-one replacements.

41. It is proposed that existing dwellings that are renovated would not be eligible for the new build exemption, because renovations alone do not clearly increase housing supply. The chapter consults on whether there might be a way to verify that a dwelling that was previously uninhabitable has been substantially renovated so that it is of a similar standard to a new build.

Exemption from interest limitation (chapter 8)

42. Cabinet has agreed in principle to consult on how to exempt property purchased on or after 27 March 2021 and within 12 months of receiving its CCC from the proposed interest limitation rules (CAB-21-MIN-0045 refers).

43. Chapter 8 sets out the proposed design of the new build exemption from the interest limitation rules (the new build exemption). It proposes that early owners (those who acquire a new build no later than 12 months after its CCC is issued, or add a new build to their land) would be eligible for the new build exemption. This differs slightly from what Cabinet agreed, because the chapter proposes the date of acquisition be irrelevant to whether a property is considered a new build – instead what is important is whether a CCC for a new build was issued on or after 27 March 2021, and (for early owners) whether the property was acquired no later than 12 months after CCC was issued.

44. This is consistent with what Ministers agreed for new builds acquired off the plans before 27 March that receive their CCCs on or after that date (IR2021/181 refers). It means that a person who already owns land as at 27 March 2021 who decides to

add a new dwelling to the land after that date would be eligible for the new build exemption, which is consistent with the objective of increasing new housing supply.

45. The impact of the new build exemption on house prices and on the supply of new builds will depend on both the length of the exemption and whether it can be passed on to subsequent investors:

Impact on house prices

45.1 **Length of the exemption:** A longer exemption allows for more interest deductions by investors. Therefore, a longer exemption will dampen house prices by less than a shorter exemption.

45.2 **Ability to pass on the exemption:** The ability to pass on the exemption to subsequent purchasers supports resale value and will dampen house prices by less than if the exemption cannot be passed on.

Impact on supply of new builds

45.3 **Supply response:** The removal of interest deductibility could reduce the incentive to build in the short run, by reducing house prices. Since longer exemptions have less impact on house prices, it follows that longer exemptions and allowing the exemption to be passed on to subsequent buyers could have less negative impact on housing supply than shorter exemptions. However, the extent to which interest limitation will reduce housing supply remains unclear.

46. The chapter consults on how long the exemption should apply to early owners for. Options mentioned include applying the exemption in perpetuity or for a fixed period such as 10 or 20 years.

47. The chapter consults on whether subsequent purchasers (those who acquire a new build more than 12 months after the new build's CCC is issued and within a fixed period such as 10 or 20 years from the date that CCC is issued) should qualify for the exemption. It also consults on what fixed period the exemption should apply to subsequent purchasers, should they be eligible for the exemption.

48. If the Government decides that the exemption applies to subsequent purchasers, the chapter proposes that subsequent purchasers would only be able to apply the exemption to new builds that receive their CCC on or after 27 March 2021. This differs from early owners. The Government has already announced the exemption would apply to early owners of new builds acquired on or after 27 March 2021 that received their CCCs before 27 March, provided the new build is acquired no later than 12 months after its CCC is issued. The reason for only allowing subsequent purchasers to access the exemption for new builds that receive their CCCs on or after 27 March 2021 is to make the rules simpler, so the only information a subsequent purchaser has to refer to when determining whether the exemption applies is the date a new build's CCC was issued.

49. The chapter consults on whether a new build should cease to qualify for the exemption once it has been used as a main home, regardless of whether it is rented out in the future. It also consults on whether special rules should be put in place to ensure large-scale purpose-built rental developments continue to be feasible in New Zealand.

Five-year new build bright-line test (chapter 9)

50. Cabinet has agreed that new builds will be exempt from the 10-year bright-line test and instead the existing five-year bright-line test will apply.

51. Chapter 9 sets out the proposed design of the five-year new build bright-line test. It proposes that the new build bright-line test would apply the settings of the 10-year bright-line test (such as the new time-based apportionment rule for the main home exclusion), but with a five-year bright-line period. In line with the standard bright-line test rules, the new build bright-line period would begin on the date the person receives title to the land regardless of when a new build is added. The new build must receive its CCC by the time it is sold for the new build bright-line test to apply.

Rollover relief (chapter 10)

52. Chapter 10 proposes that rollover relief would apply to transfers of residential property in certain situations for the purposes of the bright-line test and the proposed interest limitation rules.

What is rollover?

53. Rollover relief is not an exemption from income tax. Generally speaking, rollover simply defers the taxing point until there is a subsequent disposal of the property that does not qualify for rollover relief. Rollover relief essentially disregards an intervening disposal by treating the transfer as a disposal and acquisition for an amount that equals the total cost of the residential land to the transferor at the date of the transfer. For the purposes of the bright-line test, this also involves deeming the recipient to take on the transferor's original date of acquisition.

54. Limited rollover relief is currently available under the bright-line test. Rollover relief is currently only provided for residential land transferred under a relationship property agreement and for amalgamations. However, full relief is provided in relation to inherited property and it is effectively exempted from the bright-line test.

Proposals

55. In the context of the interest limitation proposal, rollover relief is being proposed to ensure that an existing property owner can still benefit from the full four-year phase-out period even if they change how they hold a property, provided there is no change in economic ownership. Rollover relief is also proposed for the interest limitation if the new build exemption is to apply to early or initial purchasers of new builds in perpetuity.

56. For the bright-line test, the proposals in this chapter would ensure that taxpayers are not brought into the bright-line test simply because they would like to settle a property on trust, for example.

57. For interest limitation, the discussion document proposes that rollover relief would be provided regardless of whether there is no consideration, partial consideration, or full consideration for the transfer of the land. However, for the bright-line test, rollover relief would be limited to situations where there is no consideration due to complexities with apportionment that would need to be accounted for.

58. As a starting point, the discussion document proposes to extend the existing relief provided for the bright-line test to the interest limitation rules (that is, for transfers under relationship property settlements, on death, and as part of a company amalgamation). It also proposes that rollover relief would be available in the following situations:

    58.1 **Natural persons disposing of land to themselves**, for example, transferring land from sole ownership to joint tenancy or from joint tenancy to tenants in common;

58.2 **Settling land on trust**, provided that: every settlor of the land is also a beneficiary of the trust; at least one of the settlors of the land is a principal settlor of the trust; and every beneficiary (excluding the beneficiaries who are also principal settlors) is associated with a principal settlor;

58.3 **Transfers to or from look-through companies (LTCs)** where the persons disposing of the land to the LTC (or acquiring it from the LTC) are all shareholders in the LTC in proportion to their individual interests in the land and in proportion to their cost base relative to the total cost base in the land;

58.4 **Transfers to or from partnerships** where the persons disposing of the land (or acquiring it from the partnership) are all partners in the partnership and their respective partnership interests are in proportion to their individual interests in the land and in proportion to their cost base relative to the total cost base in the land.

59. The chapter does not seek to address all possible structures used to hold residential property, merely the most common scenarios where integrity risk is limited and focusses on structures that are likely to be used by unsophisticated investors. Officials consider that family trusts, look-through companies, and partnerships would cover a major segment of the population.

60. Stakeholders are likely to request rollover relief or a full exemption for other transactions that can result in an income tax liability arising under the bright-line test, often in the context of family arrangements where the taxpayer is not aware of the potential tax consequences of their actions.

61. For example, parents may help their children onto the property ladder by gifting them residential land or selling it to them below market value (for example, at cost). Under the Income Tax Act 2007, these transactions are deemed to occur at market value. This is an important feature of New Zealand's tax system to ensure integrity and fairness, as it provides a backstop against abuse and tax avoidance behaviour. However, it can create cash-flow difficulties when an income tax liability arises under the bright-line test.

62. These transactions are not dealt with in the discussion document due to the primary focus on the proposed interest limitation rules, and the complexity and numerous iterations of these arrangements. Any proposals would need to be carefully considered within the broader context of the tax system and ensure that the risk of abuse is minimised.

Technical issues

Interposed entities (chapter 11)

63. Chapter 11 proposes interposed entity rules to support the integrity of the interest limitation rules. Under current law, taxpayers are normally allowed interest deductions on loans used to acquires shares in a company. Without interposed entity rules, a taxpayer could claim an interest deduction for borrowings used to acquire shares in a company that owns residential property (the company is "interposed" between the shareholder's borrowing and the residential property).

64. The discussion document therefore proposes to deny interest deductions on loans used to acquire ownership interests in an entity (the "interposed entity"), if the entity holds a certain amount of residential property subject to interest limitation ("affected assets").[1] For interposed close companies and trusts, the amount of

[1] "Affected assets" would not include new builds or properties that qualify for the development exemption.

interest denied is proportionate to the amount of affected assets held, by value. For widely held interposed entities, all interest is proposed to be denied if more than 50 percent of the entity's total assets are affected assets.

65. The tax treatment under the proposed interposed entity rules is harsher in three respects than if the residential property were held directly by the borrower:

    65.1 **Full interest denial for interests in widely held interposed entities:** As noted above, it is proposed that full denial will apply for widely-held interposed entities. This may deny interest on loans partly used, indirectly, for non-residential purposes. For example, a taxpayer who borrows to acquire shares in a widely held company owning 70 percent residential rentals (old builds) and 30 percent new builds by value will be denied 100 percent of their interest expenditure, rather than 70 percent.

    65.2 **No phasing:** For all existing interposed entity structures, interest incurred by the borrower on or after 1 October 2021 will be subject to full denial.

    65.3 **Treatment on sale:** Chapter 5 outlines options for the treatment of interest expenditure when a taxpayer who directly holds residential land sells the land. Most options allow previously denied interest deductions in some circumstances (for example, if the sale is taxed). The proposed interposed entity rules do not allow previously denied interest deductions in any circumstances (for example, if the entity sells its residential land for a taxable gain). This may be perceived as inconsistent with the options suggested in Chapter 5.

66. Officials have suggested the proposed tax treatment due to simplicity. It is expected that existing interposed entity structures are not widespread. The proposed rules would create a further disincentive to use such structures.

Implications for rental loss ring-fencing (chapter 12)

67. The existing residential loss ring-fencing (RLR) rules restrict the tax benefits of residential property investments. The interest limitation rules will further reduce tax benefits from such investments. There will likely be significant interplay between the proposed interest limitation rules and the existing RLR rules.

68. Chapter 12 discusses the overlap of the RLR rules and the proposed interest limitation rules and the proposed exemptions, and the technical issues that are likely to arise. The chapter also raises the question of whether the new build exemption should be an exemption for RLR as well as interest limitation. Doing this would give greater effect to the new build exemption and simplify the interaction of the rules, but it would also reduce the tax impost on some (new build) residential property compared with the current rules.

Interaction with mixed-use asset (MUA) rules (chapter 13)

69. The focus of the proposed interest limitation rules is on debt relating to residential investment property, but they will also apply to baches and other second homes if they are used to earn income. Chapter 13 considers how the proposal will be coordinated with the existing mixed-use asset (MUA) rules, recognising that:

    69.1 the MUA rules have their own allocation rule and interposed entity rules that apply when a MUA is owned by a close company; and

    69.2 the interest limitation rule means that not all MUAs will be treated the same way in terms of interest deductibility.

Administrative impacts

70. Limiting interest deductions will involve increased administration costs for Inland Revenue over an extended period while different rules based on the acquisition date and nature of properties continue to be in place. These costs will arise from managing an increased number of customer contacts and supporting the integrity of the rules. This means a mixture of providing people with information to increase awareness and making sure that Inland Revenue uses its full range of interventions to support customers in meeting their obligations right from the start, through to enforcement action, where there is clear evidence of deliberate non-compliance. This will involve:

    70.1 ongoing proactive marketing and targeted education campaigns, followed by one-on-one interventions such as community compliance visits and integrity checks;

    70.2 developing appropriate tools to assist customers to determine eligibility;

    70.3 improving our data and analytical capability; and

    70.4 taking audit action to address deliberate non-compliance.

71. Inland Revenue will work with The Treasury to consider the costs to support the administration of the rules and options to fund these changes, and will confirm this in the September Cabinet paper.

Fiscal implications

72. Limiting interest deductions will raise revenue within the forecast period and officials will provide an estimate of this revenue in the report on submissions due in early September. The report will seek final policy approval for design and include the draft Cabinet paper.

Communications

73. A communications plan is being developed between Inland Revenue and the Ministry of Housing and Urban Development. The focus is on gaining detailed feedback from professional bodies in the tax and property communities. Each agency will be contacting key stakeholders to encourage them to make a submission. The discussion document will be hosted on Inland Revenue's tax policy website, and submissions will be made by email.

74. We also expect there to be interest in what is being consulted on from owners of multiple residential properties and their tax agents. We are not planning to proactively communicate with or solicit submissions from the public. However, to help them understand the scope of the consultation we will be producing five or six summary sheets covering the main issues and pointing them to the discussion document for technical detail. We do not intend to distribute these widely, but for them to be available on the tax policy website.

75. Media queries will be directed to Inland Revenue's Policy communications staff, who will work with the relevant Ministers' Offices to coordinate responses.

Next steps

76. The discussion document will be released for public consultation in early June, with public consultation on the proposals open for five weeks. The next steps following the closing date for submissions are as follows:

- 2 September – Report on submissions and final policy approval for design with draft Cabinet paper.
- 16 September – Lodgement of Cabinet paper.
- 22 September – Consideration by the Economic Development Committee (DEV).
- 27 September – Consideration by Cabinet.
- Late September – Release of Supplementary Order Paper.

 04.

In Confidence

Minister of Finance

Minister of Housing

Minister of Revenue

Chair, Cabinet

RELEASE OF DISCUSSION DOCUMENT – DESIGN OF THE INTEREST LIMITATION AND ADDITIONAL BRIGHT-LINE RULES

Proposal

1. Cabinet previously agreed in principle to limit deductions for interest incurred on residential investment property and to exempt new builds from both the proposed interest limitation rules and the extended bright-line test. Cabinet also directed officials to consult with stakeholders on the design details before seeking final decisions from Cabinet (CAB-21-MIN-0045 refers). Attached to this paper is a draft Discussion Document on the detailed design of the rules. Minor changes may be made to the Discussion Document before it is released.

2. We intend to release the Discussion Document *Design of the interest limitation and additional bright-line rules* in June, followed by 5 weeks for consultation. The aim is for Cabinet consideration of the final policy design to occur on 27 September, and for the legislation implementing these changes to be released in late September 2021.

3. The Discussion Document consults on:

4. **Residential property affected by the interest limitation rules (chapter 2).** The chapter proposes that the rules would cover residential property located in New Zealand (excluding the family home). It outlines the issues in defining the types of property that would be impacted by the rules. The chapter proposes that a main home used to earn income would not be subject to the rules. In other words, an owner-occupier who rents out part of their home can continue to deduct interest against that rental income.

5. **Entities affected by the interest limitation rules (chapter 3).** The chapter proposes, as a starting point, that all taxpayers would be subject to the interest limitation rules. However, companies are generally allowed deductions for interest without needing to trace the use of their borrowed funds. It is proposed that the interest limitation rules would override this general rule for closely-held companies and residential investment property-rich companies, so that taxpayers cannot get around the rules by using such companies to borrow to acquire residential investment property. The chapter also proposes that the rules would not apply to Kāinga Ora and its wholly-owned subsidiaries.

6. **Interest subject to limitation (chapter 4).** Where a loan is used for a mixture of taxable and non-taxable purposes it is already necessary to trace what the loan is used for to determine deductibility (unless the borrower is a company). This chapter proposes the same approach be applied for loans used to fund residential investment property. It also covers refinancing an existing loan and transitional issues relating to debt drawn down on properties acquired before 27 March 2021.

7. **Disposals of property subject to interest limitation (chapter 5).** This chapter considers whether interest deductions should be allowed in some cases when capital gains are taxed upon the disposal of a property. Allowing interest to be deducted on disposal where capital gains are taxable would better align the rules with income tax principles, by allowing expenses to be recognised when income is fully taxed.

8. **Exemption for property development (chapter 6).** The Government has decided in-principle that property development should be exempt from the proposed interest limitation rules. This is consistent with the policy objective of increasing housing supply through the construction of new builds. This chapter considers the definition of "development" and the scope of the development exemption. It also considers options for applying the exemption to one-off developments and to land dealers.

9. **Exemption for new builds (chapters 7, 8 and 9).** The Government has decided that newly-built residential properties should be exempt from the proposed interest limitation rules, and that a 5-year bright-line test will apply to new builds instead of the extended 10-year bright-line test. Chapter 7 proposes a definition of a "new build" for these purposes. Chapter 8 considers the design of the new build exemption from the proposed interest limitation rule, including the period for which the new build exemption would apply and whether it should apply to the initial (or early) purchaser or to the property for a fixed period (such as 20 years). Chapter 9 considers the design of the five-year new build bright-line test.

10. **Rollover relief (chapter 10).** This chapter proposes some limited rollover relief to deal with transfers to trusts, as well as transfers where there is no significant change in ownership. Rollovers are disposals that are disregarded for the purposes of applying some provisions. The chapter is relevant to both the proposed interest limitation rules and the bright-line test.

11. **Technical design issues (chapters 11, 12 and 13).** Chapter 11 proposes interposed entity rules. These rules would ensure that taxpayers cannot claim interest deductions for borrowings used to acquire residential investment property indirectly through an interposed entity. Chapters 12 and 13 cover how the interest limitation rules would interact with other tax rules such as the rental loss ring-fencing rules (which restrict the tax benefits of residential investment property) and the mixed-use asset rules (which is where a property is used partly to derive income, partly for private use, and is not in use for a period of time – for example, a bach).

12. **Compliance and administration (chapter 14).** This chapter considers the administrative aspects of the proposed interest limitation rules and the changes to the bright-line test. It outlines the Government's proposed approach to administering these changes so that the rules work, taxpayers comply with them, and the Government has sufficient information to assess their effectiveness.

Financial Implications

13. Releasing the Discussion Document will not have any fiscal implications. Any fiscal implications resulting from the proposals will be included in final policy advice to Cabinet following consultation.

Legislative Implications

14. The release of the Discussion Document will not give rise to any immediate legislative implications. Legislative changes will be necessary to implement the proposals. It is proposed that the changes are included in a Supplementary Order Paper to an omnibus taxation bill in late September 2021.

Impact Analysis

15. A RIA panel at Inland Revenue has reviewed and confirmed, the Discussion Document substitutes for an interim Regulatory Impact Statement. The Discussion Document is likely to lead to effective consultation and support the delivery of quality Regulatory Impact Analysis to inform subsequent decisions.

Population Implications

16. Releasing the Discussion Document will not have any population implications. Any population implications resulting from the proposals will be included in final policy advice to Cabinet following consultation.

Human Rights

17. The proposals contained in the Discussion Document are not inconsistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Communications

18. Communications will be undertaken by Inland Revenue, Te Tūāpapa Kura Kāinga - Ministry of Housing and Urban Development and Te Puni Kōkiri. The goal is to gain detailed feedback from the tax, property and Māori communities. Each Department will contact key stakeholders to encourage them to make a submission. The Discussion Document will be hosted on Inland Revenue's tax policy website, and submissions will be made by email.

19. There is expected to be interest from owners of multiple residential properties and their tax agents. Officials will not proactively communicate with or solicit submissions from the public. However, to help the public understand the scope of the consultation, six summary sheets (drafts attached) will be produced covering the main issues. These will be available on Inland Revenue's tax policy website.

20. Media enquiries to all agencies will be sent to Inland Revenue's policy communications staff, who will work with the relevant Ministers' Offices to coordinate responses.

Recommendations

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

1. **note** that Cabinet directed officials to consult with stakeholders on the design details of the interest limitation and additional bright-line rules before seeking final decisions from Cabinet (CAB-21-MIN-0045);

2. **note** that a Discussion Document titled *Design of the interest limitation and additional bright-line rules* is attached for this purpose;

3. **invite** the Minister of Finance, Minister of Housing and Minister of Revenue to report back to Cabinet on the outcome of the consultation and final policy recommendations in September.

Authorised for lodgement

Hon Grant Robertson
Minister of Finance

Hon Dr Megan Woods
Minister of Housing

Hon David Parker
Minister of Revenue

05.

CAB-21-MIN-0204

Cabinet

Minute of Decision

This document contains information for the New Zealand Cabinet. It must be treated in confidence and handled in accordance with any security classification, or other endorsement. The information can only be released, including under the Official Information Act 1982, by persons with the appropriate authority.

Design of the Interest Limitation and Additional Bright-line Rules: Release of Discussion Document

Portfolios **Finance / Housing / Revenue**

On 8 June 2021, Cabinet:

1 **noted** that in March 2021, Cabinet directed officials to consult with stakeholders on the design details of the interest limitation and additional bright-line rules before seeking final decisions from Cabinet [CAB-21-MIN-0045];

2 **noted** the contents of the discussion document titled *Design of the interest limitation rule and additional bright-line rules* (the discussion document), attached to the submission under

CAB-21-SUB-0204;

3 **approved** the release of the discussion document, subject to any minor or technical changes that may be authorised by the Minister of Finance, Minister of Housing, and Minister of Revenue;

4 **noted** that the discussion document is intended to be released for five weeks from June 2021;

5 **invited** the Minister of Finance, Minister of Housing and Minister of Revenue to report back to Cabinet on the outcome of the consultation and seeking agreement to final policy recommendations in September 2021.

Michael Webster
Secretary of the Cabinet

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 T2021/1935

Action sought

	Action sought	Deadline
Minister of Finance	**Agree** to recommendations **Note** the contents of this report	12 August 2021
Minister of Revenue	**Agree** to recommendations **Note** the contents of this report	12 August 2021
Minister of Housing	**Agree** to recommendations **Note** the contents of this report **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 **ONE** 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

 OR

 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 **ONE** 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

 OR

 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

 OR

 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 **ONE** 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

 OR

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

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) [redacted]

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)

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

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) [redacted] 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 • Interest expense $150,000 • Interest deducted $150,000 Net result: net deduction of $50,000 Tax loss equals economic loss on property	• Capital gain (not taxed) $100,000 • Interest expense $150,000 • Deduction for interest in excess of untaxed capital gain $50,000 Net result: net deduction of $50,000 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]

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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.

Inland Revenue
Te Tari Taake

POLICY AND REGULATORY STEWARDSHIP

TE TAI ŌHANGA
THE TREASURY

Tax policy report: **Interest limitation on residential investment property and associated bright-line changes – final policy recommendations**

Date:	25 August 2021	**Priority:**	High
Security level:	In Confidence	**Report number:**	IR2021/341 T2021/2180

Action sought

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

25 August 2021

Minister of Finance
Minister of Revenue

Interest limitation on residential investment property and associated bright-line changes – final policy recommendations

Executive summary

Purpose

This report seeks your decisions on the final policy design of the interest limitation proposal.

Context and background

The most recent report to you on the interest limitation project sought some early decisions on the design of the interest limitation proposal and attached a summary of the submissions received on the discussion document *Design of the interest limitation rule and additional bright-line rules* (IR2021/325; T2021/1935 refers). Ministerial decisions on the general design and approach of the proposal have also been made on the basis of earlier reports (IR2021/133; T2021/847; and IR2021/181 refer). This report seeks your decisions on the remaining policy design issues and highlights the specific issues that are less straightforward in nature and/or are likely to be contentious.

Key policy decisions

In particular, the remaining decisions about what should and should not be included in the scope of the interest limitation proposal are not necessarily clear-cut, and the creation of various boundaries will unavoidably add to the complexity of the proposed rules. There are arguments both for and against various exclusions for types of residential property, or for types of entities that may hold residential property which need to be considered and weighed. Another area for consideration is if and how the rules are to apply to Māori collectively-owned land. It has become apparent to officials following consultation that the proposed rules as they were outlined in the discussion document may not provide the appropriate policy outcome in relation to Māori land. Therefore, some special rules or exclusions may be needed to address these specific issues.

The main issues requiring your consideration include the following:

Residential property subject to interest limitation

- Whether there will be exclusions from the interest limitation rules covering the following categories of residential property:
  - Multiple dwellings on a single title, for example, a block of flats that are all on the same legal title.

- – Short-stay accommodation that is not suitable for long-term habitation by an owner-occupier or tenant (for example, a purpose-built unit that does not include standard amenities).
- – Boardinghouses.

Māori collectively-owned land

- Whether the interest limitation rules should apply to Māori customary land, Māori freehold land, Crown land reserved for Māori, or land set apart as a Māori reservation, including for example papakāinga housing as well as kaumātua housing near or on a marae.
- Whether the interest limitation rules should apply to housing provided on general title land held by a Māori authority (or an entity eligible to be one) to a shareholder or beneficiary, for instance, papakāinga and kaumātua housing provided to iwi/hapū. This could include old kaumātua flats transferred to iwi and hapū by the Government.
- Whether land acquired by a Māori authority (or an entity eligible to be one) under a Te Tiriti o Waitangi – The Treaty of Waitangi (Te Tiriti) settlement or a post-Treaty settlement mechanism (for example, through a right of first refusal) should be excluded from the interest limitation rules.
- Whether different requirements for rollover relief should be provided for disposals to a trust that is a Māori authority or is eligible to be a Māori authority, or where land received as settlement of a claim under Te Tiriti by a representative is disposed of to trustees who will then manage the land for Māori claimants.

Entities specifically excluded from interest limitation

- Whether Kāinga Ora and its wholly-owned subsidiaries should be excluded from the interest limitation rules.

New build issues

- Whether the definition of "new build" for the new build exemption should also apply for the purposes of the new build bright line test. Officials recommend that "new build" be defined to mean a self-contained dwelling that is added to residential land and receives its code compliance certificate (CCC) on or after 27 March 2020.
- Whether the new build exemption will apply to existing dwellings that have been significantly remediated.
- Whether a five-year bright-line test will apply to new builds located in New Zealand that are acquired on or after 27 March 2021 and no later than 12 months after receiving their CCCs.
- Where interest expense relates to both an existing dwelling and a new build on the same title, whether an apportionment rule should apply based on existing tax principles.
- If a main home makes up more than half of a parcel of land, whether the main home exemption should apply for the purposes of both the new build bright-line and 10-year bright-line tests.
- If the main home makes up less than half of the land, whether a time-based apportionment rule should apply instead. Under such a rule, the main home portion of the land would not be taxed under the bright-line test, but the non-main home

portion of the land would be taxed if it is disposed of within the applicable bright-line period.

Fiscal implications

Officials estimate limiting interest deductions (with a 20-year new build exemption) will generate around $1.12 billion in revenue over the forecast period, although this estimate is highly uncertain. As investors are likely to increasingly reallocate to new builds, officials expect that revenues from this policy will decline from 2026. As a result, this is unlikely to provide a sustainable revenue source to fund permanent expenditure, which you should consider in the process of setting your fiscal strategy.

Next steps

Officials propose to discuss the design decisions outlined in this report with you at the regular joint Ministers' meeting on 30 August. On the basis of your decisions on these matters, we will provide you with a draft Cabinet paper on 9 September for consideration at the Economic Development Committee on 22 September.

It is intended that the amendments implementing these decisions will be included in a Supplementary Order Paper to the 2021 omnibus tax bill at the Select Committee stage. Officials are seeking your agreement in this report to consult on specific aspects of the draft legislative wording with a limited group of trusted private sector experts.

Recommended action

We recommend that you:

Residential property subject to interest limitation

1. **agree** that where a residential property and commercial property are on the same title (dual-purpose buildings), an apportionment approach based on existing tax principles should apply to exclude the commercial aspect of the property from the interest limitation rules;

   Agreed/Not agreed   Agreed/Not agreed

2. **agree** that multiple dwellings on a single title should not be excluded from the interest limitation rules;

   Agreed/Not agreed   Agreed/Not agreed

3. **agree** that short-stay accommodation should not be excluded from the interest limitation rules;

   Agreed/Not agreed   Agreed/Not agreed

4. **agree** that boardinghouses should not be excluded from the interest limitation rules, but hostels will be excluded;

   Agreed/Not agreed   Agreed/Not agreed

Māori collectively-owned land

5. **agree** that the interest limitation rules should not apply to Māori customary land, Māori freehold land, Crown land reserved for Māori, or land set apart as a Māori reservation;

Agreed/Not agreed Agreed/Not agreed

6. **agree** that the interest limitation rules should not apply to housing provided by a Māori authority or an entity eligible to be a Māori authority to a shareholder or beneficiary of that entity;

Agreed/Not agreed Agreed/Not agreed

7. **agree** that the interest limitation rules should not apply to land acquired by a Māori authority or entity eligible to be a Māori authority under a Treaty settlement or a post-Treaty settlement mechanism;

Agreed/Not agreed Agreed/Not agreed

8. **agree** that rollover relief will be provided where land is disposed of to a trust that is a Māori authority, or is eligible to be a Māori authority, where the person or persons disposing of the land and the beneficiaries of the receiving trust are all either:

    8.1.1 members of the same iwi or hapū; or

    8.1.2 the descendants of any tipuna (living or dead);

Agreed/Not agreed Agreed/Not agreed

9. **agree** that rollover relief be provided for any disposal to the trustees of a trust who, on behalf of Māori claimants, receive and manage land that is transferred by the Crown as part of the settlement of a claim under Te Tiriti;

Agreed/Not agreed Agreed/Not agreed

Entities specifically excluded from interest limitation

10. **agree** to exclude Kāinga Ora and its wholly-owned subsidiaries from the interest limitation rules;

Agreed/Not agreed Agreed/Not agreed

11. **agree** that if the Minister of Finance, Minister of Social Development and Employment and Minister of Housing decide to allow Kāinga Ora tenants to receive the accommodation supplement, the scope of the Kāinga Ora exemption should be re-examined;

Agreed/Not agreed Agreed/Not agreed

12. **agree** that companies that are not close companies and not residential property-rich will be excluded from the interest limitation rules;

Agreed/Not agreed Agreed/Not agreed

13. **agree** that a close company that is not residential property-rich will be excluded from the interest limitation rules if:

    13.1 it is a Māori Authority or eligible to be a Māori Authority; or

13.2 it is wholly owned by a Māori Authority or a trust or entity eligible to be a Māori Authority;

Agreed/Not agreed Agreed/Not agreed

14. **agree** that the residential property-rich threshold be set at 50 percent of the company's total assets;

Agreed/Not agreed Agreed/Not agreed

Interest allocation

15. agree to **ONE** of the following options for loans drawn down before 27 March 2021 that cannot be retrospectively traced:

15.1 Stacking *(recommended)*;

Agreed/Not agreed Agreed/Not agreed

OR

15.2 Apportionment;

Agreed/Not agreed Agreed/Not agreed

Development exemption

16. **agree** that the development exemption should apply to:

16.1 interest relating to land acquired for the purpose of a land-owning business (acquired for subdivision, development, dealing, and erecting buildings) that is subject to tax on sale; and

16.2 interest relating to other land that is used for subdivision, development, or erecting buildings and is intended to create a new build;

Agreed/Not agreed Agreed/Not agreed

Definition of new build

17. **note** that you have agreed that the new build exemption will apply to a new build that receives its code compliance certificate (CCC) on or after 27 March 2020 (IR2021/325; T2021/1935 refers);

18. **agree** to define a "new build" to mean a self-contained dwelling that is added to residential land and receives its CCC on or after 27 March 2020;

Agreed/Not agreed Agreed/Not agreed

19. **agree** that a new build includes:

19.1 a dwelling added to bare land, including where an existing dwelling on the land is replaced with one or more dwellings;

Agreed/Not agreed Agreed/Not agreed

19.2 a dwelling added to land that shares the same title with an existing dwelling;

Agreed/Not agreed Agreed/Not agreed

19.3 an existing dwelling that is converted into multiple self-contained dwellings;

Agreed/Not agreed Agreed/Not agreed

19.4 a commercial building that is converted into dwellings;

Agreed/Not agreed Agreed/Not agreed

New build exemption

20. **note** that you have agreed the new build exemption will apply to a new build until 20 years after the date its CCC is issued;

21. **agree** that the new build exemption will not apply to existing dwellings that have been significantly remediated (except in accordance with recommendation 19.3), but that officials will report to Ministers on options regarding remediated dwellings later this year;

Agreed/Not agreed Agreed/Not agreed

22. **agree** that an apportionment rule based on existing tax principles will apply where interest is for borrowings that relate to both an old build and a new build;

Agreed/Not agreed Agreed/Not agreed

Five-year bright-line test for new builds

23. **agree** that a five-year bright-line test will apply to new builds located in New Zealand, which are acquired on or after 27 March 2021 and no later than 12 months after receiving their CCCs;

Agreed/Not agreed Agreed/Not agreed

24. **agree** that unless there is a main home on the land, where a new build is on the same title as an existing dwelling, space-based apportionment rules will apply so that only the portion of the land attributable to the new build will be subject to the five-year new build bright-line test;

Agreed/Not agreed Agreed/Not agreed

25. **agree** that the same main home exemption will apply to both the 10-year bright-line and new build bright-line tests;

Agreed/Not agreed Agreed/Not agreed

26. **agree** to amend how the main home exemption works on a space basis for both the 10-year bright-line and new build bright-line tests, so that:

26.1 if residential land is predominantly used as a main home, then no gains on sale will be taxed under either bright-line test (subject to the time apportionment rules referred to in recommendation 27 below); and

26.2 if residential land is not predominantly used as a main home, then space-based apportionment rules will apply so that the portion of the land attributable to the main home is not taxed under the new build or 10-year bright-line tests (subject to the time apportionment rules referred to in recommendation 27 below);

Agreed/Not agreed Agreed/Not agreed

27. **agree** that the time apportionment rules that were introduced alongside the 10-year bright-line test, which ensure that tax is paid on a property if it has not been used as a main home for more than 12 consecutive months, will continue to apply to the 10-year bright-line test and will also apply to the five-year new-build bright-line test;

Agreed/Not agreed Agreed/Not agreed

Interposed entities

28. **agree** that the rule for closely-held interposed entities (close companies and trusts) will apply an apportionment approach (that is, interest limited will be proportionate to the amount of affected residential property held);

Agreed/Not agreed Agreed/Not agreed

29. **agree** that the rule for interposed entities that are non-close companies will apply an all-or-nothing approach (that is, interest is fully limited if the amount of affected residential property held is more than 50 percent of total assets);

Agreed/Not agreed Agreed/Not agreed

Rollover relief

30. **agree** that rollover relief will apply to settlements of land on family trusts and transfers between the owners of a look-through company (LTC) or partnership and the LTC or partnership, subject to the conditions outlined in the appendix to this report;

Agreed/Not agreed Agreed/Not agreed

Minor, technical and straightforward amendments

31. **note** that the appendix to this report contains officials' recommendations in relation to the more minor, technical, detailed or straightforward aspects of the design of the interest limitation proposal and associated bright-line changes;

Legislative implications

32. **agree** to include the above amendments in a Supplementary Order Paper to the 2021 omnibus tax bill at the Select Committee stage;

Agreed/Not agreed Agreed/Not agreed

33. **agree** that officials may consult on specific aspects of the draft legislative wording with a limited group of trusted private sector experts;

Agreed/Not agreed Agreed/Not agreed

Fiscal implications

34. **note** that officials estimate limiting interest deductions (with a 20-year new build exemption) will generate around $1.12 billion over the forecast period, with a corresponding impact on the operating balance and net core Crown debt, but that this estimate is highly uncertain;

Table 1: Revenue from limiting interest deductions (20-year new build exemption)

Vote Revenue Minister of Revenue	2021/22	2022/23	2023/24	2024/25
Tax revenue ($m)	80.000	200.000	350.000	490.000
Total operating	(80.000)	(200.000)	(350.000)	(490.000)

35. **note** that officials estimate that the revenue gained from limiting interest deductions will decline after 2026 as investors increasingly reallocate towards new builds, so it is unlikely to provide a sustainable revenue source to fund permanent expenditure;

Referral

36. **refer** copies of this report to the Minister of Housing, the Associate Minister of Housing (Public Housing) and Associate Minister of Housing (Māori Housing) for their 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

Purpose

1. This report seeks your decisions on the final policy design of the interest limitation proposal.

Background

2. The most recent report to you on the interest limitation project sought some early decisions on the design of the interest limitation proposal and attached a summary of the submissions received on the discussion document *Design of the interest limitation rule and additional bright-line rules* (IR2021/325; T2021/1935 refers). Ministerial decisions and in-principle decisions by Cabinet on the general design and approach of the proposal have also been made on the basis of earlier reports. You have already made decisions on some of the key policy design features, including the following:

   2.1 Deductions for previously denied interest expense will be allowed in the year of sale of the property but only if the sale is taxable, subject to any losses being ring-fenced to taxable gains from property sales.

   2.2 Transitional, emergency and public housing will be explicitly excluded from the interest limitation rules but with a sunset clause on the exclusion.

   2.3 Qualifying new build properties will be exempt from the interest limitation rules up until 20 years from the date a new build's code compliance certificate (CCC) is issued.

3. A decision on whether purpose-built rentals (PBR) will be subject to the interest limitation rules will be sought at Cabinet.

4. This report seeks your decisions on the remaining policy design issues that have yet to be decided. The following sections set out the outstanding issues on which decisions are sought. The appendix outlines officials' recommendations in relation to the more minor, technical or straightforward aspects of the detailed design of the rules.

5. It is intended that the amendments implementing these decisions will be included in a Supplementary Order Paper to the 2021 omnibus tax bill at the Select Committee stage. Officials are seeking your agreement in this report to consult on specific aspects of the draft legislative wording with a limited group of trusted private sector experts.

Residential property subject to interest limitation

6. The interest limitation rules should apply to property that is commonly and foreseeably used to provide residential accommodation on a long-term basis, and in particular, could be used as a private owner-occupied residence. That is, the rules should apply where the physical structure is suitable for long-term residential habitation. This underlying principle is relevant to determining all properties within the scope of the rules – regardless of whether they are actually being used at any given time as owner-occupied residential property. It is their capacity to be used as such that matters.

7. The discussion document proposed using existing definitions and concepts in the Income Tax Act 2007 as a starting point. The problem is that these may lead to outcomes that do not fit with the underlying principle set out above. This inevitably leads to line calls on whether marginal cases should be inside or outside the rules.

8. The following discussion examines these issues in light of the underlying principle in relation to:

   8.1 multiple dwellings on a single title;

   8.2 short-stay accommodation;

   8.3 boardinghouses; and

   8.4 dual-purpose buildings on a single title.

Multiple dwellings on a single title

9. Submissions raised the question of multiple dwellings on a single title. This issue has some similarities with the purpose-built rentals (PBR) issue. Given broader interest in PBR, we wanted to bring these submissions to your attention. While there are some differences, in particular one of scale, both asset classes operate on similar principles.

10. A common example raised by submitters was a small block of flats with between four and 12 units. Physically, they share the same characteristics as a standard block of flats where a single flat can be purchased. The only difference is the way in which the flats are titled – legally all the flats are on a single title and must be purchased at the same time.

11. Submitters argued that these buildings should not be in scope because the dwellings are not separately unit titled. A potential buyer would have to purchase the entire building rather than a single dwelling which makes them an unlikely choice for owner-occupiers looking for an affordable home. As an asset class, submitters argued that these properties are only attractive to investors and should not be considered substitutable for owner-occupied housing.

Recommendation

12. Officials do not recommend an exclusion for these types of buildings. This is because the underlying principle is for the rules to apply to properties suitable for long-term occupation regardless of the legal structure.

13. The reference in the discussion document to the ability to use the property (or part of the property) as a private owner-occupied residence relates to whether the property could function as an owner-occupied property, not whether it is likely an owner-occupier would purchase the property. Relevant factors include whether it is self-contained or reliant on shared facilities. A conventional hotel room, for example, which is not self-contained, would not satisfy this test.

Short-stay accommodation issues

14. The discussion document sought submissions on whether certain types of short-stay accommodation should be excluded from the rules, and how an exclusion could be designed without creating an incentive for investors to convert their long-term residential rental properties into short-stay accommodation in order to circumvent the interest limitation rules. Submissions on this were mixed. Some submitted that all short-stay accommodation should be excluded from the rules regardless of suitability for long-term habitation.[1] They favoured tying this category to GST

[1] Note that by "short-stay accommodation", we mean accommodation generally advertised on digital platforms rented out as part of the so-called sharing economy. This term was misinterpreted by some submitters who suggested an exclusion for short-stay accommodation should also cover purpose-built emergency accommodation and temporary housing. This issue has been dealt with separately.

registration on the basis that an accommodation provider above the registration threshold should be regarded as a commercial business. Providers below the registration threshold would not be excluded.

15. This is unsatisfactory because the supply of accommodation is generally exempt from GST if the premises are occupied by the person as their principal place of residence (that is, long-term rental accommodation). At $300 per night, for example, a property would satisfy the GST registration threshold with an occupancy rate of only 200 nights of accommodation per year. This means that linking into the GST rules would not resolve our concerns about conversion risk as there are no structural barriers that would prevent an investor from converting a long-term rental property into short-stay accommodation.

16. Other submitters thought that properties would need to be suitable only for short-stay accommodation and that guidance would need to be developed to identify such properties.

Recommendation

17. Again, the issue comes down to the functional nature of the property itself and whether it is suitable for long term residential accommodation. Drawing a distinction based on features such as a minimum number of bedrooms in a property or units on a piece of land would be possible, but any such distinction would be arbitrary and would create boundary issues for other types of properties where submitters consider an exclusion should be available based on scale. Therefore, officials do not recommend an exclusion for short-stay accommodation at this time.

Boardinghouses

18. The discussion document proposed an exclusion for commercial accommodation predominantly designed for short-term use on a commercial basis, often at scale, on the grounds that these are straightforward to distinguish from properties that could be a private owner-occupied residence. Boardinghouses were included in this list, along with hotels, motels, and hostels. However, following submissions and further consideration, officials recommend that boardinghouses should not be specifically excluded from interest limitation.

19. In reality, boardinghouses are not straightforward to identify. Several submitters requested clarity on what is meant by the term, which is not defined in the Income Tax Act 2007 (the ITA). A similar term ("boarding house") is used in the Residential Tenancies Act 1986 (the RTA); some submitters believed that this definition would apply, and several opposed an exclusion on this basis as boardinghouses do not greatly differ from regular residential properties. It is uncertain whether the RTA definition would apply (although it is not intended to), but Inland Revenue has struggled to define "boardinghouse" for other areas of tax or clearly indicate what constitutes one. While some services need to be provided, it is unclear what the required level of servicing is, and it would ultimately depend on the specific facts and circumstances.

20. An exclusion could create an incentive to convert existing long-term rental properties into boardinghouses to circumvent interest limitation. There are few structural barriers preventing this: larger boardinghouses may be structurally similar to hostels and thus not suitable for owner-occupation, but smaller boardinghouses tend to resemble standard residential properties. Distinguishing between them is not straightforward. A distinction based on features such as a minimum number of bedrooms may be possible, but any such distinction would be arbitrary and create boundary issues for other areas where submitters consider an exclusion should be available based on scale.

21. Exclusions should provide certainty and be objectively clear for taxpayers to determine whether the rules apply to them. Officials consider that an exclusion for boardinghouses would have the opposite effect. Uncertainty could lead to non-compliance or deliberate restructuring to get around the interest limitation rules. Inland Revenue may not be able to identify these cases, particularly as New Zealand's tax system is based on self-assessment and voluntary compliance.

Recommendation

22. As there is insufficient certainty around the definition of a boardinghouse to sustain an exclusion without undermining the integrity of the rules, officials recommend that boardinghouses should not be excluded from the rules. Officials consider that many true commercial and larger-scale boardinghouses would also be covered by the term "hostel", which would be excluded. While hostel is also undefined in the ITA, officials consider there to be less risk and ambiguity.

Dual-purpose buildings on a single title – apportionment issues

23. The interest limitation rules would apply to land that has an in-scope residential property on it. It is not intended that the interest limitation rules would apply to commercial properties such as office buildings or shops. In some cases, it is possible that a commercial property and a residential property may be on the same title.

24. The bright-line test contains an exclusion for residential land that is predominantly used as business premises. This exclusion operates on an all-or-nothing basis based on predominant use (effectively a "more than 50 percent" test). If the business premises are more than 50 percent of the total residential land, they are fully excluded; if not, they are fully included. This is a simple test meant to provide certainty and reduce compliance costs for the bright-line rules. However, in the context of the proposed interest limitation rules, this could lead to harsh or arbitrary outcomes for dual-purpose buildings on a single title compared with a building where the commercial aspect is on one title and the residential accommodation on another.

25. The discussion document asked for feedback on whether the predominant use approach used for the bright-line test could be appropriate for interest limitation, or whether an apportionment approach would better achieve the intended purpose. All submitters on this issue favoured an apportionment approach and most favoured using existing tax principles.

Recommendation

26. Officials recommend an apportionment approach based on existing tax principles.

Māori collectively-owned land

Papakāinga, kaumātua and other community housing

27. The discussion document considered issues relating to housing on Māori collectively-owned land. It considered potential impacts of interest limitation on Māori and sought feedback from the public on whether papakāinga housing, kaumātua housing, or other forms of Māori community housing should be excluded from the interest limitation rules.

28. Public submissions on this issue were generally in favour of an exemption. Submitters agreed that papakāinga housing does not generally compete with housing on the regular market, making it a good candidate for an exemption. Only

one submitter specifically commented on kaumātua housing. The submitter noted kaumātua housing serves a similar purpose to retirement homes and other care facilities, and an exemption on this basis would be consistent. Some also noted that Māori are disproportionately affected by housing unaffordability and special consideration should be given to their needs. A few submitters disagreed with the proposal on the grounds that it would give preferential treatment to a particular ethnic group and may create division among New Zealanders.

29. Officials consider that certain Māori housing should be excluded from the interest limitation rules and that an exclusion can be designed without undermining the integrity of the rules.

30. There is no set definition of papakāinga housing. However, officials met with interested parties to better understand how housing is provided to whānau and whether there are any trends or certain models that are followed that might assist in developing an appropriate exclusion based on existing frameworks or tax concepts.

31. Papakāinga housing is a mix of owner-occupied housing and rental housing. Housing provided to whānau is found on both Māori land and general title land. Where the housing is on Māori land, bank lending is difficult to obtain due to the legal nature of the land. In addition, permission to reside on the land will be granted by an occupation order or a licence to occupy. Some entities are charities or community housing providers; some have elected to be Māori authorities while others have not. They can range from iwi-provided papakāinga to a few properties managed by a smaller Ahu Whenua Trust. Not all will seek expert tax advice when setting up their papakāinga and some may sit at the periphery of the tax system.

32. This means that an exclusion needs to be broad to ensure that it is not just available to those who are well advised or structure a papakāinga development in a certain way. An exclusion also needs to be robust. There needs to be minimal risk that it could be inappropriately accessed by residential property investors (for example through conversion or substitution) while also being straightforward for taxpayers to apply and for Inland Revenue to administer. Conversion and substitution of investments are less likely to occur where there is a strong regulatory framework in place and where there are limits regarding who may occupy or purchase the property.

Recommendation

33. In the first instance, officials recommend that the interest limitation rules should not apply to Māori customary land, Māori freehold land, Crown land reserved for Māori, or land set aside as a Māori reservation.[2] This would cover both papakāinga housing, as well as kaumātua housing near or on a marae. The use of and ability to reside on Māori land is subject to the provisions of the Te Ture Whenua Māori Act 1993 and the jurisdiction of the Māori Land Court. Due to the strong regulatory framework in place, property investors would not be able to convert general title land to Māori land simply to avoid the application of the interest limitation rules. Māori land is not substitutable for a residential investment property on general title land as it is not straightforward to purchase or invest in Māori land and it is difficult to secure bank lending against Māori land.

34. Due to limitations regarding use, officials also understand that it is uncommon for housing on Māori land to be rented to the general population in a commercial rental arrangement. Officials are therefore satisfied that the risk of this limb of the exclusion applying too broadly is low.

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[2] Not all of this land will have residential property on it and so would be outside the scope of the rules regardless, but an exclusion would provide certainty.

35. Given that papakāinga housing can be on general title land, officials also recommend that the interest limitation rules should not apply to housing provided by a Māori authority (or an entity eligible to be one but which has not made the relevant election) to a shareholder or beneficiary of that Māori authority (or eligible entity). This limb of the exclusion is more complex because a Māori organisation may hold rental properties as a property investor. In this situation, the interest limitation rules should apply. It is for this reason that officials recommend an additional requirement that the housing must be provided to a beneficiary or shareholder for that residential property to be excluded from the scope of the interest limitation rules. This should limit the scope of the exclusion to members of an iwi, hapū or whānau, but would cover both papakāinga and kaumātua housing.

Treaty settlements

36. Property investors are generally able to sell their investments when an investment is no longer financially viable. It is expected that some property owners will sell their existing residential properties because of the interest limitation rules. This is not necessarily undesirable as it is a natural consequence of the Government's objective to tilt the playing field towards owner-occupiers and first home buyers.

37. However, this may not be an appropriate outcome in the context of a Te Tiriti o Waitangi – The Treaty of Waitangi (Te Tiriti) settlement, given the role of Treaty settlements in acknowledging and addressing Crown breaches of Te Tiriti. It may not be appropriate to expect Treaty settlement land to be sold if it is no longer economically viable because of the interest limitation rules.

38. A related issue is the use of ground leases by Māori authorities and entities eligible to be Māori authorities. You agreed that ground lessors should not be excluded from the scope of the interest limitation rules (IR2021/325; T2021/1935 refers). That report noted that special consideration should be given to the use of ground leases by Māori authorities or entities eligible to be Māori authorities. This is particularly relevant in the Treaty settlement context where ground leases are not uncommon due to the nature of the land. The land may not be able to be sold, or due to the cultural significance it may not be appropriate to sell it. However, it may not be economic or within the landowner's broader strategy to become an active residential landlord. Therefore, to ensure productive use of the land, a ground lease structure with a term of 99 or more years, for example, may be one of the few options available. Particularly in the case of existing ground leases, it would not be possible for the ground lessor to exit/cancel the ground lease.

Recommendation

39. Officials therefore recommend that land acquired by a Māori authority (or entity eligible to be one) under a Treaty settlement or a post-Treaty settlement mechanism (for example, through a right of first refusal) should also be excluded from the interest limitation rules. This should include land that is subsequently transferred by the post-settlement governance entity to members of the claimant group. If land is then sold commercially to a third party, the new owner should be subject to the rules.

40. In the context of ground leases, this exclusion should apply to the ground lessor (being the Māori authority or eligible entity that owns the Treaty settlement land) but not to the lessee. That is, where a property investor holds a leasehold interest in a residential property on Treaty settlement land, they should still be subject to the interest limitation rules as this investment would be substitutable for other residential investment property.

41. The proposal addresses an additional equity concern that may arise between iwi groups – those that have already settled would otherwise be impacted by the

interest limitation rules, whereas iwi groups that are still in negotiations could either seek additional redress for the tax impact or seek other remedies via tax indemnities from the Crown. For the latter, both remedies are complex and could have downstream implications. It may therefore be simpler to exclude Treaty settlement property from the scope of the rules.

42. Officials have consulted with a number of interested parties, including some iwi and hapū, who have expressed support for these proposals.

Rollover relief for disposals to Māori land trusts

43. The discussion document sought additional feedback on whether specific rollover relief provisions would need to be designed for collectively-owned Māori land to ensure that the interest limitation rules and bright-line test operate as intended.

44. Our consultation on the rollover relief proposal for land held collectively by Māori through trusts (both Māori land and general land owned by Māori subject to the Te Ture Whenua Māori Act 1993) indicated that a specific provision of rollover relief may be useful in the most likely types of restructuring scenarios.

Recommendation

45. In addition to the proposal for general family trusts (which could apply for all types of trusts), officials recommend that rollover relief be provided where:

    45.1 the land is disposed of to a trust that is a Māori authority, or is eligible to be a Māori authority; and

    45.2 the person or persons disposing of the land and the beneficiaries of the receiving trust are all:

        45.2.1 members of the same iwi or hapū; or

        45.2.2 the descendants of any tipuna (living or dead).

46. The bright-line test may also be too broad in the context of settlements under Te Tiriti. Where land is received as settlement of a claim under Te Tiriti by a representative and is disposed of within the relevant bright-line period to a trust for Māori claimants (for example, where it is transferred from the post-settlement governance entity to hapū), the disposal may be subject to the bright-line test. Therefore, officials also recommend that rollover relief be provided for any disposal of land to the trustees of a trust who, on behalf of Māori claimants, receive and manage land that is transferred by the Crown as part of the settlement of a claim under Te Tiriti.

Entities specifically excluded from interest limitation

47. In general, when determining who and what should be subject to the interest limitation rules, officials have preferred exclusions on a property basis over an entity basis. This is because entities may hold different assets for different purposes. For example, a taxpayer that operates a retirement village could also hold many residential rental properties. Excluding retirement village operators on an entity basis would therefore also exclude those ordinary rental properties from the interest limitation rules, contrary to the policy intent.

48. Officials have only recommended two entity-based exclusions, both of which are largely for compliance cost reasons.

Kāinga Ora and its wholly-owned subsidiaries

49. The discussion document proposed to exclude Kāinga Ora and its subsidiaries from the interest limitation rules. Some submitters argued that this exclusion would give Kāinga Ora a tax advantage, which officials disagree with. Instead, the exclusion would ensure the tax treatment of Kāinga Ora under the interest limitation rules is the same as for other taxpayers. Registered community housing providers and registered charities are usually exempt from income tax and will therefore be unaffected by interest limitation. Kāinga Ora also provides public housing, but under law it cannot be a registered community housing provider[3] and it is unlikely[4] that Kāinga Ora, as a Crown agency can be registered as a charity, notwithstanding that it carries out the same activities as many charities that provide community housing.

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

Recommendation

51. Officials recommend excluding Kāinga Ora and its subsidiaries from the interest limitation rules on the basis that all their current activities involve either public housing or property development (which would be covered by the development exemption in any case). s 9(2)(f)(iv) [redacted]

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

Non-close companies that are not residential property-rich

53. You have previously agreed that the discussion document would include the option of not applying the interest limitation rules to companies that are not close companies nor residential property-rich (IR2021/133; T2021/847 refers). The purpose of this proposed exclusion is to minimise compliance costs for companies whose core business does not involve residential property but who may still hold some residential property. An example is a company that buys bare land intending to use it as business premises. Until that land is used as business premises it could still be considered "residential property" if zoning rules allow a dwelling to be built on it. Such companies would usually be able to achieve the same tax outcome by allocating debt to their other business asset, but this can have high compliance costs. Officials therefore recommend excluding companies whose residential property is less than 50 percent of the value of their total assets.

54. A 50 percent threshold is consistent with the existing "residential land-rich" threshold in the loss ring-fencing rules. Companies will only be excluded if they stay below this threshold at all times in the income year. However, most companies

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[3] The definition of "community housing provider" in section 2 of the Public and Community Housing Management Act 1992 explicitly excludes Kāinga Ora.

[4] The law is not entirely clear on this and a Crown Law opinion would be required to confirm it.

whose core business does not involve residential property will be well below the threshold, so will not have to constantly monitor their residential property percentages.

Recommendation

55. Officials also recommend extending this exclusion to close companies that are Māori authorities (or eligible to be a Māori authority) or wholly-owned subsidiaries of Māori authorities (or of entities eligible to be Māori authorities), provided the close company is not residential property-rich. The reason officials initially suggested applying the rules to all close companies was because close companies are controlled by one or a small number of individuals so the potential for avoidance is higher. However, a company that is a Māori authority or owned by a Māori authority will often technically be a "close company" because it is owned by a single trust, even though the trust itself may have many (sometimes thousands of) beneficial owners.[5] In substance, most Māori authorities are more akin to widely-held companies than to close companies. The potential for avoidance is also low, as an individual cannot easily set up a Māori authority to hold their ordinary rental property.

Interest allocation (transitional issue)

56. Taxpayers may not be able to retrospectively trace some loans that were drawn down before 27 March 2021. This may occur even if a taxpayer has complied with all their legal record-keeping obligations, because previously they did not need to trace whether their borrowings were applied to residential property or to other business purposes. Taxpayers have always needed to trace borrowings applied to private purposes (such as buying a family home) so the options listed below would not apply to these "private" loans.

57. The discussion document consulted on two options for bringing these pre-27 March loans into the interest limitation rules:

    57.1 **Stacking**. Under this option, the pre-27 March loans are allocated first to the market value of the taxpayer's other business assets before being allocated to residential property.

    57.2 **Apportionment**. Under this option, pre-27 March loans are apportioned across the taxpayer's residential and other business assets based on the assets' costs.

58. The vast majority of submitters preferred stacking, with several submitters wanting the option of being able to choose between the two. Officials consider that allowing taxpayers to choose between stacking and apportionment would create undue complexity and recommend against it.

Recommendation

59. Officials recommend stacking on the basis that it is fairest for taxpayers and would significantly lower compliance costs. Well-advised taxpayers would be able to restructure to achieve the same tax outcome as would be achieved using stacking anyway, and most of these restructures would be very difficult to detect and challenge. Moreover, this transitional rule would only affect pre-27 March loans so

[5] There are restrictions on Māori Authorities to ensure they are representative of, and accountable to, their members. Similar restrictions do not apply to ordinary discretionary trusts. An ordinary discretionary trust could therefore have thousands of beneficiaries, but only ever make distributions to a small number of its beneficiaries.

its impact will be limited. Stacking is also more consistent with Ministers' desire not to affect loans for other business purposes when compared with apportionment.

Loss ring-fencing

60. Many submitters have asked that loss ring-fencing be repealed in light of interest limitation. Loss ring-fencing prevents residential property investors from offsetting losses from property investments against their other income. Given the proposed limitation of interest deductions, loss ring-fencing could be considered much less relevant and repealing it would simplify the taxation of property. However, because interest will remain deductible for investments in new builds, retaining loss ring-fencing for new builds may have some merit. To retain or repeal the loss ring-fencing rules is a fundamental issue and officials have not been in a position to properly consider the issue.

Recommendation

61. Officials recommend retaining loss ring-fencing at this stage. The issue may be raised again by submitters when the legislation is considered by the Finance and Expenditure Committee and officials will report to you as part of that process.

Development exemption

62. As decided by Cabinet, officials have consulted on an exemption for interest incurred by an owner of residential land used for development. We recommend that:

    62.1 interest incurred with respect to land acquired for use in a land-owning business of development, subdivision, dealing or erecting buildings be covered by the development exemption; and

    62.2 the exemption also be available for interest incurred in relation to other land used for development, subdivision or erecting buildings for the purpose of creating one or more new builds (as defined below).

63. Issues regarding remediated property are discussed at paragraphs 68 to 72 below.

Definition of new build

64. You have agreed that new builds which receive their CCCs on or after 27 March 2020 would qualify for the new build exemption until 20 years from the date of the CCC (IR2021/325; T2021/1935 refers). The exemption would generally apply from the date a CCC is issued for a person who adds a new build to their land, or from the date of acquisition where a person acquires a new build that already has its CCC.

65. For the five-year new build bright-line test, a new build would have to be acquired on or after 27 March 2021, and would need to have its CCC by the time it is disposed of. It would also need to be acquired no later than 12 months after the new build receives its CCC because, unlike the exemption from interest limitation, the bright-line test only applies to the initial owner of a new build.

66. To ensure the rules for new builds are as simple as possible, officials recommend the same definition of new build apply for both the new build exemption from interest limitation (new build exemption) and the new build bright-line test.

Recommendation

67. A property should generally only qualify as a new build where there is an increase in residential housing supply. Officials recommend that "new build" be defined to mean a self-contained dwelling that is added to residential land and receives its CCC on or after 27 March 2020.

68. It would not matter whether a dwelling is made from brand new materials, or whether the dwelling is constructed on-site. It would therefore include modular homes and relocated dwellings. The definition would include the types of new builds set out in the discussion document, which submitters generally supported. These include:

    68.1 **Simple new builds**, which is where a new build is added to bare land. It includes where an existing dwelling on the land is replaced with one or more new dwellings.

    68.2 **Complex new builds**, which is where a new build is added to land but shares the same title with an existing dwelling. The dwellings do not have to be on separate titles. The new build can be standalone, or attached to the existing dwelling (added above, below or beside the existing dwelling).

    68.3 **Multi-dwelling conversions**, which is where an existing dwelling is converted into multiple self-contained dwellings. For example, a two-story single unit dwelling is converted so the two floors become two separate self-contained dwellings. Both of these units would be considered new builds.

    68.4 **Commercial to residential conversions**, which is where a commercial building is converted into dwellings.

Remediation and uninhabitable dwellings

69. The discussion document asked submitters whether remediation work (including significant renovations of uninhabitable dwellings) should make an existing dwelling eligible for the new build exemption. Many submissions on this issue were in favour of providing an exemption for existing dwellings that have been remediated.

70. Properties that are owned and remediated by a professional developer or dealer will generally qualify for the development exemption for the period they are owned by the developer or dealer. However, the development exemption would not apply for remediation work performed if the owner of the land is not a professional developer or dealer. For example, if a taxpayer is not in the business of development or dealing and they contract another party to remediate a property that they own, then that remediated property would not qualify for the development exemption.

71. If remediated dwellings were to qualify, what qualifies would have to be clearly defined given the rules would impact many New Zealanders. "Remediation" could encompass anything from a simple renovation, such as adding a new room to a dwelling, to extensive renovations undertaken to remediate a leaky or earthquake-prone building. Alternatively, any house that was previously "uninhabitable" could qualify once it has undergone remediation and become habitable again. Depending on which remediated dwellings qualify, the rules could create perverse incentives. For example, if an uninhabitable dwelling qualifies after remediation, this could incentivise property investors to leave existing dwellings to deteriorate so that they qualify as "uninhabitable" before then remediating them.

72. Just as the definition of new build is tied to CCCs, it is important that whether a remediated dwelling qualifies is objectively verifiable. If not, there is a risk that allowing remediated dwellings to qualify could undermine the objective of the interest limitation rules, by providing property investors with a way to bring

additional existing dwellings within the scope of the new build exemption without necessarily creating new housing stock.

Recommendation

73. Officials recommend that neither exemption applies to existing dwellings that are remediated at this stage (except to the extent remediation by a dealer or developer would qualify under the development exemption). We will continue to undertake policy work on how best to include some remediated existing dwellings within the scope of the development and new build exemptions without undermining broader policy objectives.

New build and existing dwelling on same title

74. The new build exemption and the five-year new build bright-line test would apply to residential land that has a new build on it:

    74.1 The exemption would allow any interest that relates to a new build to be deducted. This includes interest on borrowings to acquire residential land that a new build is on; to construct a new build; or to fund other expenses such as maintenance, rates, or insurance.

    74.2 Under the five-year new build bright-line test, the new build would only be taxed on sale under the bright-line test if it is disposed of within five years of acquisition.

75. Where a new build and an existing dwelling are on the same title, there is a need for some rules to ensure that only the new build benefits from both the new build exemption from interest limitation and the five-year new build bright-line test.

Recommendation

76. Where interest relates to both an existing dwelling and a new build (such as where a loan covers the cost of acquiring land that has both an existing dwelling and a new build on it) then officials recommend applying an apportionment rule based on existing tax principles. The interest attributable to the new build would be deductible provided there is sufficient nexus with an income earning activity. The interest attributable to the existing dwelling would not be deductible because the interest limitation rules would apply.

77. Where a new build and an existing dwelling on residential land acquired on or after 27 March 2021 are on the same title, officials recommend that only the portion of the land with the new build on it would be subject to the five-year new build bright-line test. The 10-year bright-line test would apply to the portion of the land with the existing dwelling on it. This means that if land with a new build and an existing dwelling on it is sold seven years after acquisition, the new build portion would not be taxed under the new build bright-line test but the old build portion would be taxed under the 10-year bright-line test. Existing tax principles for apportionment would apply.

Changes to the main home exemption from the bright-line test

78. The main home exemption currently applies where more than half the land is used as a main home (this is referred to as a space-based predominance test). This means that under current law, the main home exemption can result in the main home being subject to tax where less than half of the land is used as a main home. For example, if two rental properties were built on the same title as a main home

and those rental properties took up more than half the land, then the main home exemption would not apply. Gains on the rental properties and the main home would be taxed if the land was sold within the applicable bright-line period.

79. A 10-year bright-line test is significantly longer than five years. Extending the test in this way makes it more likely that main homes will be taxed on sale where they make up less than half of the land (because the main home exemption, in its current form, would not apply).

Recommendation

80. Officials recommend the following rules apply under the new build and 10-year bright-line tests in relation to a main home on residential land:

    80.1 If a main home makes up more than half of the land, then the main home exemption would apply in accordance with the current law. Any gain on sale would not be taxed under the new build bright-line or 10-year bright-line tests.

    80.2 If the main home exemption does not apply because the main home makes up less than half of the land, an apportionment test would apply instead. Under the apportionment test, the main home portion of the land would not be taxed under the bright-line test, but the non-main home portion of the land would be taxed if it is disposed of within the applicable bright-line period.

81. Overall, these changes would ensure that a main home is never taxed under the new build or 10-year bright-line tests while it is being used as a main home. A person who builds a granny flat on the same section as their main home would continue to benefit from the main home exemption. The main home would also not be taxed even where the portion of the land used as a main home is smaller than the non-main home portion.

Interposed entities

82. Interposed entity rules ensure that taxpayers who borrow to acquire residential property indirectly are still subject to interest limitation. The rules are inevitably complex, but submitters generally agreed that there is a need for such rules.

83. An interposed entity may or may not be closely held. Close companies and trusts would be considered closely-held entities. Taxpayers who have an ownership interest in a closely-held entity will usually be able to access information about that entity’s assets without much difficulty. Moreover, closely-held interposed entities usually have fewer assets, and their assets are less likely to change significantly over the course of an income year. It is also more likely that taxpayers will try to use closely-held interposed entities for tax avoidance (in the absence of interposed entity rules).

Recommendation

84. Officials therefore recommend having a different rule for closely-held interposed entities (that is, close companies and trusts) than for other interposed entities. In broad terms, the two rules would work as follows:

    84.1 For closely-held interposed entities, the rule would be more accurate in that it would apply an apportionment approach. The amount of interest limited under the rule would be proportionate to the amount of residential property (excluding new builds and development property) held by the interposed entity.

84.2 For other interposed entities, the rule would be simpler and apply an "all-or-nothing" approach. If more than 50 percent of the value of an interposed entity's assets are residential property (excluding new builds and development property), 100 percent of the taxpayer's interest deductions traced to the interposed entity would be denied.

Rollover relief

85. The discussion document proposed limited rollover relief for both the proposed new interest limitation rules and the bright-line test.

86. Rollover simply ignores a transaction for tax purposes. In the context of the bright-line rules, this means that the transaction does not trigger the bright-line test. Currently, only limited rollover relief is available under the bright-line test for relationship property and company amalgamations. The discussion document proposed limited extensions to bright-line rollover (which were also proposed to apply for interest limitation purposes) for settlements of land on family trusts or transfers between the owners of a look-through company (LTC) or partnership and the LTC or partnership. Submitters wanted the proposed relief to be extended much further to associated persons transactions more generally. This is a significant change which raises a number of integrity concerns that would need to be considered and which cannot be done in the limited time available.

Recommendation

87. For the reasons outlined above, officials do not recommend extending rollover relief beyond the situations outlined in the discussion document, aside from the extensions recommended in relation to Māori land at paragraphs 42 to 45 and the changes described in the appendix.

Fiscal implications

88. Officials estimate limiting interest deductions (with a 20-year new build exemption) will generate around $1.12 billion over the forecast period as indicated in Table 1 below. This updates the estimate The Treasury provided in T2021/967 and incorporates your design decisions for the policy, including providing a 20-year exemption for new builds.

Table 1: Revenue from limiting interest deductions (20-year new build exemption)

Vote Revenue **Minister of Revenue**	**2021/22**	**2022/23**	**2023/24**	**2024/25**
Tax revenue ($m)	80.000	200.000	350.000	490.000
Total operating	(80.000)	(200.000)	(350.000)	(490.000)

89. This estimate is highly uncertain because:

89.1 It incorporates behavioural assumptions about how residential property investors will react to the policy.

89.2 It incorporates the interaction between the interest limitation policy, rental loss ring-fencing, and the rules which tax residential property on sale, such as the bright-line test (as interest deductions are allowed on the taxable sale of properties). These interactions are uncertain, as these policies are relatively recent and there is limited data to draw on.

89.3 There are data limitations regarding the total amount of interest investors are currently deducting, and future interest rates and housing market conditions.

90. The most significant assumption officials have made is that residential property investors will increasingly reallocate their residential investments towards new builds. This significantly decreases the revenue from interest limitation, including reducing revenue by approximately $300 million in the 2024/25 year.

91. Officials expect that the revenue gained from limiting interest deductions will peak at approximately $650 million in 2026 and then decline as investors increasingly reallocate towards new builds. The declining revenue from limiting interest deductions means it is unlikely to provide a sustainable revenue source to fund permanent expenditure. The Treasury therefore recommends that you factor this likely decline into account when you set your wider fiscal strategy and do not look to fund additional permanent spending from additional short-term revenues.

Administrative implications

92. Inland Revenue will be responsible for implementing and administering the changes and will require additional funding to do so. Officials are in the process of developing an estimate of the additional costs and considering funding options for discussion with The Treasury. These will be provided with the draft Cabinet paper in early September. Given the complexity of the new rules, the wide variety of taxpayers affected and the short timeframe for implementation, the main focus will initially be on communication of the changes, education and using our analytical capabilities to full effect.

93. Limiting interest deductions will involve increased administration costs for Inland Revenue over an extended period while different rules based on the acquisition date and nature of properties continue to be in place. These costs will arise from managing an increased number of customer contacts and supporting the integrity of the rules. This means a mixture of providing people with information to increase awareness and making sure that Inland Revenue uses its full range of interventions to support customers in meeting their obligations right from the start through to follow-up action, where there is clear evidence of deliberate non-compliance. This will involve:

93.1 ongoing proactive marketing and targeted education campaigns, followed by one-on-one interventions such as community compliance visits and integrity checks;

93.2 developing appropriate tools to assist customers to determine eligibility;

93.3 improving our data and analytical capability; and

93.4 taking audit action to address deliberate non-compliance.

Next steps

94. Officials propose to discuss the design decisions outlined in this report with you at the regular joint Ministers' meeting on 30 August. Once you have made decisions on the final policy design, we will provide you with a draft Cabinet paper and Supplementary Analysis Report on 9 September. The other relevant dates for Cabinet approval of the policy and the release of the Supplementary Order Paper (SOP) to the 2021 omnibus tax bill are as follows:

Lodgement of the Cabinet paper with the Cabinet Office	16 September
Consideration at DEV Committee	22 September
Cabinet approval of policy and delegation to release SOP	27 September
Public release of SOP	28 September
Finance and Expenditure Committee calls for submissions on the SOP	29 September
Submissions on the SOP close	10 November

Appendix – Detailed and technical issues

The table outlines officials' recommendations for the more minor, technical or straightforward aspects of the detailed design of the interest limitation proposal.

<table>
<tr><th>Topic</th><th>Recommendations</th></tr>
<tr><td>Residential property subject to interest limitation</td><td>That employee accommodation should be exempted from interest limitation where it meets the definitions in the residential ring-fencing rules, as proposed in the discussion document.
That student accommodation should be exempted from interest limitation, based on the regulatory framework provided by the Residential Tenancies Act 1986.
That serviced apartments, as defined in the Income Tax Act 2007, should not be specifically exempted from interest limitation.</td></tr>
<tr><td>Entities affected by interest limitation</td><td>That, in applying the rules to close companies, the existing definition of close company should be used without amendment at this stage to minimise the potential impact on other areas of tax.
That a company would be considered residential property-rich for the income year if it exceeds the residential property-rich threshold at any time during the income year.
That, in determining whether a taxpayer is residential property-rich:
the value of property subject to the development exemption will be subtracted from the value of residential property to ensure that developer companies are not affected by the rules;
the value of property subject to the new build exemption will not be subtracted from the value of residential property;
shares in a residential property-rich company will be treated as residential property to avoid the need to look through chains of company; and
the test will be applied on a wholly-owned group basis, with intra-group shares and loans (that is shares in, or loans to, another member of the wholly-owned group) disregarded in order to avoid double counting.
That, in determining whether a taxpayer is residential property-rich, asset values are determined using:
for residential property, including improvements to the land, but excluding property subject to the development exemption, the later of:
the property's most recent capital value or annual value as set by a local authority; or
either the cost of the property on acquisition or, if the transaction involves an associated person, its market value;
for all other assets (including property subject to the development exemption):
the value in the taxpayer's financial statements, if those statements are prepared in accordance with either generally accepted accounting principles, or minimum requirements prescribed by an Order in Council made under section 21C of the Tax Administration Act 1994;
in all other cases, the asset's tax value.</td></tr>
</table>

Interest allocation	• That interest on loans that fund property situated outside New Zealand will not be covered by the rules.
Disposals of property subject to interest limitation	• If interest has been denied under interest limitation, and the property is sold in a taxable (revenue account) sale, that the denied interest is potentially deductible in the year of sale. • If the sale is on revenue account because it is a bright-line sale, that the interest is treated as if it were an additional cost of the property, deductible in the year of sale (and not subject to loss ring-fencing), but the net loss from sale (including the interest amount) is deductible only to the extent of gains from the sale of the property, and other property, in the same income year or a later income year.
Development and related activities	• That the development exemption will apply on a property-by-property basis and will apply to: – interest on property that is held on revenue account under section CB 7 of the Income Tax Act 2007, from the date of acquisition; and – interest on other property used for development, subdivision and/or erecting buildings with the aim of creating a new build (by non-CB 7 taxpayers), from the commencement of the development activity. • That the development exemption will apply until the earlier of the date a code of compliance certificate is issued or when the property is sold or disposed of.
Definition of new build	• That where a hotel/motel unit is converted to a dwelling but no CCC is required, the dwelling would qualify as a new build from the date council records show the change in use took place.
New build exemption from interest limitation	• That the new build exemption applies from the date of acquisition for new builds acquired off the plans, but the 20-year fixed period is still counted from the date a new build's CCC is issued. • That the new build exemption ceases from the earlier of the date a new build ceases to be on the land it was added to or 20 years from the date the new build receives its CCC, to ensure the exemption only applies if there is a new build on the land. • That if a new build's CCC is issued subject to a B2 modification (which generally occurs when a CCC is issued more than five years after building work is substantially completed, and means that a building's durability is measured from the date of substantial completion instead of the date it receives its CCC), the 20-year fixed period the new build exemption applies for is not counted from the date the new build's CCC is issued, but instead from the date the building work for the new build was substantially completed.
New build bright-line test	• That the settings that apply for the 10-year bright-line test also apply for the five-year new build bright-line test (noting that officials have recommended changes to how the main home exclusion works for both the 10-year and new build bright-line tests).
Rollover relief	• That rollover relief (for interest limitation and bright-line purposes) will apply to settlements of residential property on a family trust (or sales to a family trust), provided that: – every settlor (or seller) of the land is also a beneficiary of the trust; – at least one of the settlors (or sellers) of the land is also a principal settlor of the trust; and

	– every beneficiary, except for the beneficiaries who are also principal settlors, has a family connection with a principal settlor (generally a person within 4 degrees of relationship of a principal settlor, or a company that person controls, or a trust of which they are a beneficiary) or is a charity. • That rollover relief (for interest limitation and for bright-line purposes) will apply to transfers to or from look-through companies (LTCs) and partnerships where the persons disposing of the land to the LTC/partnership (or acquiring it from the LTC/partnership) have ownership/partnership interests in the LTC/partnership in proportion to: – their individual interests in the land; and – their cost base relative to the total cost base in the land. • That bright-line rollover for settlements on family trusts and for transfers to or from LTCs or partnerships will only apply provided that the amount of consideration is less than or equal to the vendor’s acquisition cost and the other conditions outlined above are met (as applicable). • That for a transfer of the type described directly above except the amount of consideration exceeds the vendor’s acquisition cost, the amount of taxable income to the vendor under the bright-line test will be the actual amount of consideration instead of the market value of the land. • That interest limitation rollover relief will also apply to transfers under relationship property agreements, transfers of inherited property upon the death of the owner, and transfers as part of company amalgamations. This mirrors the existing relief available for the bright-line test. • That transfers of land to effect a change in co-ownership do not reset the bright-line clock to the extent that they do not increase a person’s proportional or notional proportional interest in the land.
Interposed entities	• That, to minimise compliance costs, the interposed entity rule for close companies and trusts will only apply when the value of residential property subject to limitation comprises at least 10 percent of the interposed entity’s total assets. • That the interposed entity rule for non-close companies will only apply when the value of residential property subject to limitation comprises at least 50 percent of its total assets. • That the apportionment calculation required under the interposed entity rule for close companies and trusts is to be calculated on a quarterly basis. • That, for the purposes of the interposed entity rules, asset values are determined using: – for residential property, including any improvements to the land, the later of: ▪ the property’s recent capital value or annual value as set by a local authority; or ▪ either the cost of the property on acquisition or, if the transaction involves an associated person, its market value; – for all other assets: ▪ the value in the interposed entity’s financial statements, if those statements are prepared in accordance with either generally accepted accounting principles, or minimum

	requirements prescribed by an Order in Council made under section 21C of the Tax Administration Act 1994; – in all other cases, the asset's tax value. • That the mixed-use asset rules are to apply in priority to the interest limitation rules for a mixed-use asset that is also residential property. • That, if interest has been allocated to a mixed-use asset that is also residential property, the asset will be excluded from the calculations required under the interposed entity rules. • That there will be a specific anti-avoidance rule to address arrangements where asset values are deliberately increased or decreased to defeat the intent and application of the interposed entities rules. • That there will be a specific anti-avoidance rule to address arrangements involving persons (and their associates) borrowing and on-lending to their interposed entities at a lower interest rate. • That look-through companies (LTCs) and partnerships should not be treated as interposed entities as they are transparent for tax purposes. • That when a person uses borrowed money to acquire an ownership interest in an LTC or partnership, the person is treated as borrowing the money to acquire an interest in any residential property owned by the LTC or partnership (in proportion to the person's effective look-through interest or partnership share). • That when a person has used borrowed money to acquire an ownership interest in an interposed company, and the company later becomes an LTC, the person is to continue applying the close company and trusts interposed entity rule to the interest expenditure on the pre-election loan even after the company becomes an LTC. • That, for simplicity, interest expenditure incurred after 1 October 2021 on money borrowed to acquire an ownership interest in an interposed entity before 27 March 2021 will be subject to full limitation instead of the four-year phasing period. • That, for simplicity, a person who uses borrowed money to acquire an ownership interest in an interposed entity will not be allowed a deduction for their interest expenditure when the person no longer holds an interest in the interposed entity, even if the ownership interest was sold for a taxable gain.
Implications for the rental loss ring-fencing rules	• That interest limitation applies before loss ring-fencing. • That interest limitation applies on a property-by-property basis only, notwithstanding that loss ring-fencing can apply on either (or both) a property-by-property or a portfolio basis.
Interest limitation and mixed-use property	• That when a loan is traced to a residential investment property, or to shares in a close company/qualifying company that owns a residential investment property, and the property is used to derive income and partly for private use: – the mixed-use asset rules in subpart DG are to apply to apportion the interest incurred in the income year between the income earning use and the private use; – the amount apportioned to private use is not allowed as a deduction; and

	– the amount apportioned to the income earning use is not allowed as a deduction under the interest limitation rule (and may be allowed as a deduction on a taxable sale of the property in the income year of sale). • That rules be enacted to achieve the above policy, including technical rules relating to the interaction of the mixed-use asset rules and the interest limitation rules.

Te Tūāpapa Kura Kāinga
Ministry of Housing and Urban Development

Briefing

Social housing exemption from interest limitation – sunset clause			
Date:	26 August 2021	**Security level:**	In Confidence
Priority:	Medium	**Report number:**	BRF21/22081081

Action sought

	Action sought	Deadline
Hon Dr Megan Woods **Minister of Housing**	**Agree** to the recommendations **Refer** copies of this briefing to the Minister of Finance, Minister of Revenue and Associate Minister of Housing (Public Housing).	2 September 2021

Contact for discussion

Name	Position	Telephone		1st contact
Claire Solon	Kaiaki, Place-based Policy and Programmes	04 831 6003	s 9(2)(a) [redacted]	
Matt Pilkinton	Senior Policy Advisor, Urban Development Regulatory Tools	04 830 6963		✓

Other agencies consulted

Inland Revenue, The Treasury

Minister's office to complete

- ☐ Noted
- ☐ Seen
- ☐ Approved
- ☐ Needs change
- ☐ Not seen by Minister
- ☐ Overtaken by events
- ☐ Declined
- ☐ Referred to (specify)

____

Comments

Date returned to HUD:

____

Briefing

Social housing exemption from interest limitation – sunset clause for leased properties

For:	Hon Dr Megan Woods, Minister of Housing		
Date:	26 August 2021	**Security level:**	In Confidence
Priority:	Medium	**Report number:**	BRF21/22081081

Purpose

1. This briefing seeks your direction on whether to have a sunset clause for the emergency, transitional, public and council housing exemption from the interest limitation rules for leased properties, and if so, the design of the sunset clause. Te Tūāpapa Kura Kāinga - Ministry of Housing and Urban Development (HUD) does not recommend a sunset clause. If Ministers wish to proceed with a sunset clause, HUD recommends at least a 10-year period (i.e. until 1 October 2031).
2. Registered community housing providers (CHPs) manage nearly 15,000 properties, of which over 9,000 are leased. Similarly, HUD and Kāinga Ora collectively lease a large number of properties for use as emergency, transitional and public housing, with lease terms up to 25 years. The CHP sector is capital-constrained, so in the absence of additional government funding, will not be able to quickly replace these properties with new-build properties. While focusing on increasing supply of new builds, Kāinga Ora will continue to lease properties from time to time to temporarily relocate tenants during major redevelopments.

Background

3. On 29 July 2021, Inland Revenue and the Treasury provided a report to the Ministers of Housing, Finance, and Revenue on key policy issues for the design of the new interest limitation rules (IR2021/325 and T2021/1935). This report included discussion on how the rules should apply to emergency, transitional, public and council housing.
4. The report noted that the interest limitation rules would generally not affect emergency, transitional or public housing properties owned by Kāinga Ora or registered community housing providers (CHPs). This is because Kāinga Ora, which is subject to income tax, is proposed to be exempt from the interest limitation rules, and CHPs will often be charities (and therefore exempt from income tax), or subject to another income tax exemption.[1]
5. However, in the absence of a specific carve-out, properties used for emergency, transitional or public housing that are leased by private landlords to CHPs, Kāinga Ora, or the Crown would be subject to the interest limitation rules. This would lead to a higher tax cost for the owners of these properties, and subsequently could lead to a reduction in the number of properties available for public housing, or an increase in the cost to CHPs or the government in procuring these properties. In addition, some council housing is provided by council-

[1] Some CHPs are not charities or eligible for another income tax exemption. Properties owned by these CHPs would be affected by the interest limitation rules in the absence of a specific carve-out for social housing properties.

controlled organisations (CCOs), which are not exempt from income tax and would be subject to the interest limitation rules.

6. On 4 August 2021, the Ministers of Housing, Finance, and Revenue met to discuss the report and agreed to exempt from the interest limitation rules all properties used for emergency, transitional, public and council housing (“the social housing exemption”). Owing to the Government’s desire to move away from the leasing model for the provision of public housing, the prospect of a sunset clause for the exemption was raised in the meeting. We understand the Ministers of Finance and Revenue’s agreement to the social housing exemption was based on the inclusion of this sunset clause for leased properties.

7. The sunset clause that has been proposed would only be for leased social housing properties. Other types of social housing would still require a permanent exemption from interest limitation (for example, properties owned by a CCO or a CHP not eligible for an income tax exemption).

Sunset clause to the social housing exemption, for leased properties only

8. The purpose of the sunset clause would be to support the Government’s intention of moving away from the leasing model for the provision of public housing. As stated in the *Public Housing Plan 2021-2024*, the Government wants to see “an increase in the number of new build public housing and a progressive decrease in the proportion of private market homes leased for public housing”. However, it is acknowledged that leasing arrangements may remain necessary in particular circumstances, particularly in priority areas where the need for social housing is most acute.

HUD does not consider that a sunset clause is necessary to support the Government’s intention of moving away from leasing arrangements

9. Te Tūāpapa Kura Kāinga – Ministry of Housing and Urban Development (HUD) does not recommend a sunset clause for the social housing exemption from interest limitation for leased properties. Continuing to provide these properties with an exemption from the interest limitation rules will not get in the way of efforts to progressively decrease the proportion of public housing properties leased from the private market. Even without a sunset clause, as the number of leasing arrangements progressively decreases, there will be fewer private market rentals eligible for the exemption.

10. As noted above, despite the intention to move away from leasing arrangements, there will be circumstances in which leased properties are still necessary to supplement the supply of social housing. This applies particularly in areas where the need for social housing is most acute, or where Kāinga Ora needs to temporarily relocate tenants to undertake major redevelopment. A sunset clause could increase the difficulty of meeting demand for social housing in these areas upon expiration of the exemption. This would be especially true if the exemption expired before the sector has been able to make significant progress in increasing the amount of non-leased social housing properties.

11. Currently CHPs manage almost 15,000 public housing properties of which over 9,000 are leased. Increasing the number of new build public housing properties and progressively decreasing the proportion of leased properties is going to take time, particularly given the capital constraints most CHPs face.

A sunset clause should not apply until at least 2031 to give sufficient time for social housing providers to move away from leasing arrangements

12. If Ministers decide a sunset clause for leased properties is necessary, HUD recommends it not apply until at least 1 October 2031 (i.e. a 10 year period) to give social housing providers enough time to make significant progress towards increasing the amount of non-leased properties. In addition, HUD recommends that any properties leased for social housing before 1 October 2031 should remain exempt from the interest limitation rules for the entirety of the leasing arrangement that has been entered into. The terms of these leasing agreements can last up to 25 years and there is a risk that the agreements could be

cancelled if the sunset clause causes the owner to become subject to the interest limitation rules.

A sunset clause should not apply to leasing arrangements between associated parties

13. There may also be some circumstances where a provider of social housing does not have legal ownership of its properties, despite having effective economic ownership. For example, a CHP may set up a special purpose vehicle (SPV) to construct and hold its properties, with the SPV leasing these properties back to the CHP. HUD recommends that any sunset clause should not apply to these sorts of leasing arrangements between associated parties. This would ensure CHPs are not required to re-structure their property holdings to avoid being impacted by the interest limitation rules upon expiration of the social housing exemption for leased properties.

Consultation

14. The Treasury and Inland Revenue were consulted on this briefing.

15. Inland Revenue would prefer that the social housing exemption not contain a sunset clause for leased properties. Inland Revenue is still working through the practical implications of administering an exemption for all housing used for emergency, transitional, public and council housing, including monitoring and verification requirements to support the integrity of the interest limitation rule. Given the inherent complexities associated with an exemption for such housing, a sunset clause for leased properties would likely be more complex due to proposed exceptions and requirements surrounding the tracking of contract dates.

Next steps

16. We recommend you discuss this briefing with your colleagues, the Minister of Finance and Minister of Revenue, and indicate to officials by 2 September whether a sunset clause for leased properties is necessary for the social housing exemption and if so, the design of the sunset clause.

Recommended actions

17. It is recommended that you:

1. **Note** that the Ministers of Housing, Finance, and Revenue agreed to an exemption from the interest limitation rules for properties used as emergency, transitional public or council housing, regardless of who owns the property.	*Noted*
2. **Note** that the agreement to the exemption was based on it being subject to a sunset clause for leased properties.	*Noted*
3. **Note** that HUD does not consider a sunset clause is necessary to support the Government's intention of moving away from the leasing model for the provision of public housing.	*Noted*
Either	
4. **Agree** to the social housing exemption from the interest limitation rules not being subject to a sunset clause for leased properties (HUD recommendation).	*Agreed/Not agreed*
Or	
5. **Agree** to a sunset clause meaning that private market rentals leased for use as social housing on or after 1 October 2031 will not be eligible for the social housing exemption.	*Agreed/Not agreed*

If you agree to recommendation 5

6. **Agree** to the following features of the sunset clause:
   - Private market rentals leased for use as social housing before 1 October 2031 will remain subject to the social housing exemption for the entire length of the leasing agreement.
   - Leasing arrangements between a social housing provider and an associated person will remain eligible for the social housing exemption.

   Agreed/not agreed

7. **Refer** copies of this briefing to the Minister of Finance, Minister of Revenue, and Associate Minister of Housing (Public Housing).

   Referred

s 9(2)(a)

Claire Solon
Kaiaki, Place-based Policy and Programmes

26/08/2021

Hon Dr Megan Woods
Minister of Housing

..... / ...... / ......

POLICY AND REGULATORY STEWARDSHIP

Tax policy report: **Cabinet Paper – Taxation of Housing: Limiting Interest Deductions for Residential Property and Changes Related to the Bright-Line Extension**

Date:	9 September 2021	**Priority:**	High
Security level:	In Confidence	**Report number:**	IR2021/382 T2021/2316 BRF21/22091096

Action sought

	Action sought	Deadline
Minister of Finance	**Sign** the attached Cabinet paper **Refer** the attached Cabinet paper to the Cabinet Economic Development Committee	15 September 2021 10am Thursday 16 September 2021
Minister of Revenue	**Sign** the attached Cabinet paper	15 September 2021
Minister of Housing	**Sign** the attached Cabinet paper	15 September 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	
Claire Solon	Kaiaki, Ministry of Housing and Urban Development	

9 September 2021

Minister of Finance
Minister of Revenue
Minister of Housing

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

Purpose

1. The attached paper is for the Cabinet Economic Development Committee to consider at its meeting on Wednesday 22 September 2021. The paper needs to be referred to the Cabinet Office by 10am on Thursday 16 September 2021.

2. In March 2021, Cabinet agreed to extend the bright-line test from 5 years to 10 years (CAB-21-MIN-0070 refers). Cabinet also agreed in-principle to limit interest deductions for residential property and to some of its key features (CAB-21-Min-0045 refers). Cabinet directed officials to consult on the detail of the proposal, with decisions to be confirmed by Cabinet following consultation.

3. The attached paper seeks Cabinet's:

   3.1 confirmation of its earlier in-principle decisions;

   3.2 agreement to key aspects of the interest limitation proposal;

   3.3 agreement to some changes relating to the bright-line test extension;

   3.4 approval of changes to appropriations to give effect to the tax reforms;

   3.5 agreement to delegate authority to the Minister of Finance and Minister of Revenue to make additional joint decisions on any policy and drafting issues arising in consultation with the Minister of Housing or Minister for Land Information as appropriate;

   3.6 agreement to delegate authority to the Minister of Revenue, in consultation with the Leader of the House, to release a Supplementary Order Paper (SOP) containing the interest limitation and bright-line measures at the Finance and Expenditure Committee stage of the Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Bill.

Key points in Cabinet Paper

4. The attached paper provides an overview of the interest limitation proposal and changes associated with the bright-line test extension. It outlines, at a high level, what the interest limitation proposal is and what it will and will not apply to.

5. The main areas to be aware of in advance of the Cabinet meeting are:

   5.1 Purpose-built rentals (also known as "build-to-rent");

   5.2 Public, council, emergency and transitional housing; and

   5.3 New build exemption.

Purpose-built rentals

6. There is likely to be discussion over whether purpose-built rentals (PBRs) should be excluded from the interest limitation proposal.

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

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

Public, council, emergency and transitional housing

9. The Cabinet paper proposes an exclusion for this type of housing to eliminate the risk of a reduction in supply. Previously, the Minister of Finance, Minister of Housing and Minister of Revenue had agreed to exclude this housing (IR2021/325; T2021/1935 refers). However, we understand that the Minister of Finance's and Minister of Revenue's support for the exclusion was based on the inclusion of a sunset provision for public housing properties leased from the private market.

10. On 26 August HUD provided a briefing to the Minister of Housing on whether to have a sunset provision for leased properties, and if so, how to design it (BRF21/22081081). This briefing recommended against having a sunset provision for leased properties. Continuing to provide the exclusion to leased properties would not hinder efforts by the Government to progressively decrease the proportion of public housing properties leased from the private market. A sunset provision for leased properties would also increase the complexity for Inland Revenue in administering the rules.

11. The Cabinet paper does not currently propose a sunset provision for leased properties. However, a sunset provision for leased properties can be added into the Cabinet paper at Ministers' direction.

New build exemption

12. In March 2021, Cabinet directed officials to consult on three options for the design and duration of the new build exemption. The new build exemption balances trade-offs between maximising the impact of interest limitation on house prices (suggesting a shorter exemption) and minimising impacts on housing supply (suggesting a longer exemption).

13. Following consultation, you agreed that the new build exemption should apply to both initial and subsequent purchasers for 20 years after a code compliance certificate (CCC) is issued (IR2021/325; T2021/1935 refers).

Financial implications

14. The estimated revenue gain from the interest limitation proposal is **$1.12 billion** over the forecast period.

	$ 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

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

16. This estimate is highly uncertain due to the assumptions and projections involved.

17. 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, especially while different rules apply during the phase-out period.

18. The complexity of the new rules, added to others for taxing property, means the resulting work items are not simple or quick to manage. The likely enactment date and the application dates also add pressure in what is a very busy period for Inland Revenue. There is a compressed impact in the final 2021/22 quarter peak for supporting customers and delivery partners to understand the immediate impact on their return filing and provisional tax payment obligations, particularly for customers without tax agents. While 82% of rental property owners have tax agents, only 52% of the customers who have interest expenses have tax agents.

19. Given the immediate effect of the rules from 1 October 2021, Inland Revenue will initially focus on providing customers and third parties with clear information and assistance to support accurate self-assessments and payments return filing. Automated analytic and intervention capabilities will be deployed, with follow-up activity for cases of obvious deliberate non-compliance. Inland Revenue expects increased customer contacts in particular following the introduction of the SOP and enactment and estimates an expected response rate of the affected customer base of 15% initially, reducing to 2% over 10 years. Additional Inland Revenue services include outbound letter campaign, marketing campaign to support customers and increase voluntary compliance, seminars and 1:1 advisory visits to present the legislative changes, proactive (compliance) actions, audit activities, technical and legal support to Inland Revenue staff, technical publications to provide certainty to customers, and delivering analytics and reporting capability to monitor and support the intelligence lead compliance approach.

20. Inland Revenue is seeking funding totalling $19.38 million over the forecast period to help meet additional administration and implementation costs of the reforms. Inland Revenue considers this amount sufficient to support the forecast revenue gain. A one-off amount is also sought in the 2022-23 fiscal year for policy work on new boundaries, definitions within the legislation and areas identified for further policy development. Some remedial legislation is expected to be required.

21. 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 the changes to the bright-line rules.

22. While funding is sought in the draft Cabinet paper over the forecast period only, Inland Revenue thinks there is significant compliance work required beyond the forecast period. This is particularly because the phase-out period over four years

means the first "standard" year when the ability to deduct interest is completely phased-out is the 2025–26 income year.

23. A summary of the estimated incremental administrative costs over 10 years are provided in the table below:

	$m – increase/(decrease)										
Vote Revenue Minister of Revenue	**2020/21**	**2021/22**	**2022/23**	**2023/24**	**2024/25**	**2025/26**	**2026/27**	**2027/28**	**2028/29**	**2029/30**	**2030/31**
Capital	**-**	**1.400**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**
Operating	-	3.580	5.920	5.260	4.620	3.090	2.570	1.950	1.780	1.650	1.520
Depreciation & Capital Charge	-	0.050	0.200	0.200	0.200	0.200	0.200	0.200	0.200	0.200	0.200
Total operating	**-**	**3.630**	**6.120**	**5.460**	**4.820**	**3.290**	**2.770**	**2.150**	**1.980**	**1.850**	**1.720**

24. Inland Revenue intends to raise out-year and on-going cost as part of future budget discussions, by which time more certainty will exist.

Next steps

25. The attached Cabinet paper will be considered by the Cabinet Economic Development Committee on Wednesday 22 September, and by Cabinet on Monday 27 September.

26. The measures outlined in the Cabinet paper will be included in an SOP to the Taxation (Annual Rates for 2021-22, GST, and Remedial Matters) Bill, which was introduced on 8 September. The SOP will be released on 28 September and the Finance and Expenditure Committee will be invited by the Minister of Revenue to consider the SOP and call for submissions on it.

27. Bill commentary for the SOP will not be published when the SOP is released, but shortly afterwards. Fact sheets and questions and answers will be provided on the SOP's release to help those affected understand the legislation.

Recommended action

We recommend that you:

28. **sign** the attached paper to the Cabinet Economic Development Committee;

Signed | Signed | Signed

29. **refer** the attached paper to the Cabinet Economic Development Committee.

Referred

s 9(2)(a)

Stephen Bond
Acting Manager
The Treasury

Chris Gillion
Policy Lead
Inland Revenue

Claire Solon
Kaiaki
Ministry of Housing and Urban Development

Hon Grant Robertson
Minister of Finance
/ /2021

Hon David Parker
Minister of Revenue
/ /2021

Hon Dr Megan Woods
Minister of Housing
/ /2021

 10.

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

Cabinet Economic Development Committee

Minute of Decision

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

Portfolios **Finance / Housing / Revenue**

On 22 September 2021, the Cabinet Economic Development Committee **referred** the submission under DEV-21-SUB-0181 to Cabinet on 27 September 2021 for further discussion.

Gerrard Carter
Committee Secretary

Present:
Hon Grant Robertson (Chair)
Hon Dr Megan Woods (Deputy Chair)
Hon Chris Hipkins
Hon Carmel Sepuloni
Hon David Parker
Hon Nanaia Mahuta
Hon Poto Williams
Hon Damien O'Connor
Hon Stuart Nash
Hon Kris Faafoi
Hon Willie Jackson
Hon Michael Wood
Hon Dr David Clark
Hon Dr Ayesha Verrall
Hon Meka Whaitiri
Hon Phil Twyford
Rino Tirikatene, MP
Dr Deborah Russell, MP

Officials present from:
Office of the Prime Minister
Office of the Chair
Officials Committee for DEV

Cabinet

Minute of Decision

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

Portfolios **Finance / Housing / Revenue**

On 27 September 2021, Cabinet:

Previous decisions

1 **noted** that on 8 March 2021, Cabinet took a series of in-principle decisions to form part of the government's broader response to housing affordability [CAB-21- MIN-0045];

2 **agreed** to the following modifications of the decisions made on 8 March 2021 [CAB-21- MIN-0045]:

2.1 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);

2.2 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);

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

Scope and exclusions

4 **agreed** 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;

5 **agreed** that the main home will not be subject to interest limitation;

6 **agreed** that public, council, emergency, and transitional housing will not be subject to interest limitation;

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

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

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

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

11 **agreed** that the interest limitation proposal will not apply to:

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

11.2 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

11.3 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;

12 **agreed** that properties located outside New Zealand will not be subject to interest limitation;

Property development and new builds

13 **agreed** 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;

14 **agreed** 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;

15 **agreed** 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

16 **agreed** that purpose-built rentals (PBRs) 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);

17 **invited** the Minister of Housing, as part of the work being undertaken on PBRs, to report back to Cabinet on the value proposition for PBRs and the case for whether this asset class should be excluded from the interest limitation rules and, if so, what criteria should apply;

Interest deductions when property is taxed on sale

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

19 **agreed** 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

20 **agreed** 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;

21 **agreed** 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

22 **authorised** the Minister of Finance and the 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 the Minister for Land Information as appropriate;

Financial implications

23 **noted** the following changes in tax revenue as a result of decisions in paragraphs 2 to 21 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

24 **agreed** that the changes in tax revenue under paragraph 23 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;

25 **noted** 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;

26 **noted** 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;

27 **noted** that to give effect to the policy decisions in paragraphs 2 to 21, Inland Revenue will incur capital costs of $1.400 million;

28 **noted** that Inland Revenue will cover the associated depreciation and capital charge from its existing baseline funding;

29 **noted** 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;

30 **noted** 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;

31 **approved** the following changes to appropriations to help meet the costs referred to in paragraph 30 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**

32 **agreed** that the expenses incurred under paragraph 30 be charged against the operating allowance of the Between-Budget Contingency;

33 **agreed** 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;

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

35 **directed** 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

36 **authorised** the Minister of Revenue, in consultation with the Leader of the House, to release a Supplementary Order Paper containing the measures in paragraphs 2 to 21 at the Finance and Expenditure Committee consideration stage of the Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Bill.

Michael Webster
Secretary of the Cabinet