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13 July 2021

Deputy Commissioner

Policy and Regulatory Stewardship
Inland Revenue Department
Wellington 6140
New Zealand

By email: **policy.webmaster@ird.govt.nz**

Dear Sir or Madam,

Design of the interest limitation rule and additional bright-line rules

CPA Australia represents the diverse interests of more than 168,000 members, including over 2,700 members in New Zealand, working in over 100 countries and regions supported by 19 offices around the world. With the assistance of our New Zealand Member Tax Committee, we make this submission on behalf of our members and in the broader public interest.

The Government's Discussion Document, **Design of the interest limitation rule and additional bright-line rules** (**the Discussion Document**), sets out the proposed design of the interest limitation rule and additional bright-line rules.

We maintain our view that this policy is an inappropriate mechanism by which to achieve the Government's housing market objectives. We believe that the tax changes proposed in the Discussion Document will not necessarily achieve the desired outcomes and will unduly complicate the tax system. We consider alternatives policies, such as increasing the supply of greenfield land and improving the planning process, will be more effective.

We also reiterate that the existing deductibility of interest expenses incurred in earning assessable income, including residential rental income, is not a tax loophole, and that this should not be the basis upon which limitations are introduced.

In response to the Discussion Document, our main comments are:

- We support the use of the Generic Tax Policy Process (**GTPP**) to develop policy and believe that use of this process would have enhanced the design of the interest limitation rule and additional bright-line rules.
- The greater the number of exemptions and carve-outs to remedy the tax distortions created by the proposed changes, the higher the likelihood that further changes will be required to ensure integrity and compliance. We anticipate it will also place pressure on professional advisers, the Inland Revenue Department (**IRD**) and other regulatory authorities to ensure compliance with the new rules.
- Taxpayers should not be retrospectively penalised for investment decisions made prior to the announced changes. Consideration should be given to protecting existing affected investors by grandfathering residential investment properties acquired prior to the Government's 27 March 2021 announcement and allowing full deductibility of interest on post-27 March 2021 borrowings traceable to the old build.
- The proposed rules should not distinguish between tenants residing in the main dwelling or a secondary residence on the property.
- An apportionment approach is more suitable in relation to business premises and dual-purpose buildings.
- Carve-outs should be provided for employee, student and short-stay accommodations.
- The use of tax values for calculating the residential investment property percentage for assets other than land, improvements and depreciable property is preferred.

- Taxpayers should be allowed the choice to use either apportionment or stacking for tracing purposes, depending on which is most appropriate.
- Pre-27 March loans in foreign currency should be afforded the same phase-out treatment as pre-27 March New Zealand dollar (**NZD**) loans.
- Option B for revenue account disposals is favoured, where deductions are allowed and deferred to the point of sale, although with a modification that upon the taxpayer triggering a re-characterisation of the land to being held on revenue account (e.g. they commence a subdivision of land within 10 years of the date of acquiring the land), the interest costs from that point forward are immediately deductible, with a wash-up calculation in the year of disposal for any interest costs incurred prior to the taxing trigger date.
- Option F for capital account disposals is favoured, as this methodology would ensure that the net real cost to the taxpayer (i.e. costs in excess of any untaxed gain) is deductible.
- The timing of the development exemption commencement should be at the point the relevant taxing provision is triggered.
- We support the inclusion of office conversions to apartments in the new build exclusion as this is likely to be an area of growth for B and C grade office blocks that have high vacancy rates post-COVID.
- Remediation of "leaky buildings", along with earthquake strengthening, should be included in the new build exemption.
- The new build exemption should apply to both early owners and subsequent purchasers, and for a fixed period.
- The five year bright-line test for new builds should apply to both early owners and subsequent purchasers.
- Roll-over relief from interest limitation should be provided for transfers on death. The time limit should be the remaining time left under the new build exemption after the transfer of the investment property to the executor/administrator of the estate or beneficiary, whichever is earlier.
- The financial arrangement rules in a cross-border transaction are, in substance, a capital gains tax as the New Zealand holder of such financial arrangements is taxed on the net wealth increase/decrease. As such, foreign exchange loss will not be able to be offset as it is not residential income. This means a New Zealand tax resident will have a ring-fenced loss and a fully taxable recovery of the interest income from the foreign exchange profits.
- We do not see any issue with adding new fields, including fields for total interest and allowable interest.

Our detailed responses are contained in the Attachment.

If you have any queries about this submission, contact Rick Jones, Country Head, New Zealand on +64 21 190 1039 or **rick.jones@cpaaustralia.com.au** or Elinor Kasapidis, Senior Manager Tax Policy on +61 3 9606 9666 or **elinor.kasapidis@cpaaustralia.com.au**.

Yours sincerely,

Dr Gary Pflugrath Executive General Manager, Policy and Advocacy	Mr Rick Jones Country Head, New Zealand

Attachment

Chapter 1 Overview of proposals and process

Tax policy process

We note that the Generic Tax Policy Process (**GTPP**) was not used to develop these interest limitation rule and additional bright-line proposals as detailed in this Discussion Document. In our view, the GTPP has proved to be very effective since its introduction in 1994 and is highly regarded worldwide.

We believe that tax policy issues can arise, including unnecessary complexity and compliance costs, when the GTPP is not used. Examples include the previous 39% marginal rate and associated changes (1990-2000), the introduction of look through companies (2010) and the reinstated 39% marginal rate and associated changes (late 2020).

It is our view that outcomes are improved when evidence-based policy is developed through external consultation over time, prior to a firm commitment to the final version of proposed changes. Feedback from stakeholders and the community will enhance the policy design and lead to better drafted legislation. The views of the Inland Revenue Department (IRD) and Treasury are key in this process and we believe that proposed rules should be reviewed before being presented to the Finance and Expenditure Committee (**FEC**). In this instance with the interest deduction denial and bright-line test extension, the policy decision appears to be contrary to advice provided to Government[1] and/or it has needed more time to analyse the implications. This creates certain risks and is likely to lead to undesirable and unintended outcomes.

While we appreciate that the detail of the interest deduction denial has been developed in a consultative document, the time frame is too short, and many of the proposals are seemingly being made without sufficient and robust evidence in support of them. Use of the tax system to achieve goals that may best be achieved through other avenues (here, the goal of more affordable housing), will, based on previous experience, most likely lead to unintended and undesirable outcomes for taxpayers. It is also unlikely to achieve the intended outcome, in this case, more affordable housing.

Our preferred approach would be further work be done to develop clearly articulated policy proposals with evidence supported by IR and Treasury, which is then put out for public consultation, and on the basis of an analysis of submissions, draft legislation be developed with sufficient time for submissions and consultation via the FEC. However, we acknowledge that in this instance, the Government is exercising its prerogative not to take this approach.

Thus, our response is premised on attempting to reduce the unintended consequences, excessive complexity and compliance costs that will be faced by taxpayers.

We urge the government to fully reinstate the GTPP and use it fully with all future policy proposals and draft legislation.

Policy design

We understand that the Government wishes to encourage the supply of new builds to the market (retaining a five-year bright-line and deduction of interest costs) and discourage the purchase of established housing by investors. Specifically, the Government intends to remove the ability to deduct interest as an expense from income from 1 October 2021, arising from residential investment property acquired on or after 27 March 2021. For residential investment properties acquired before 27 March 2021, investors' ability to deduct interest will be phased-out over four years from 1 October 2021.

The Discussion Document sets out the policy objectives of housing affordability, housing supply, efficiency, and the coherence and complexity of the tax system.

We do not agree that the existing deductibility of interest expenses incurred in earning assessable income, including residential rental income, is a tax loophole. Furthermore, section DB7 of the Income Tax Act 2007 expressly allows a deduction for interest for companies.

We also highlight that both Treasury and the IRD opposed the increase in the bright line test from five to ten years. Furthermore, the IRD favoured retaining the status quo on interest deductibility which aligns with our view that expenses incurred in earning assessable income should be deductible.

We observe that the proposed limitation of interest deductibility and additional bright-line rules will significantly increase the complexity of the tax system, as reflected in the details of the Discussion Document. The numerous exemptions and carve-outs presented throughout the Discussion Paper to remedy the tax distortions created by the proposed changes are likely to create administrative and compliance challenges and place enormous strain on investors, advisers, the IRD and other regulatory authorities to ensure compliance with the new rules.

The Government believes this change in tax policy will dampen house price growth and make it easier for people to own their own home. However, Australian research has found that if, in Australia, negative gearing was to be abolished from investment property and capital gains tax discount reduced from 50 to 25 per cent, property prices would only be 1 to 2 per cent lower than

[1] The Treasury, *Tax measures to moderate house price growth – extension of the bright-line test* (2021); available at: **https://www.treasury.govt.nz/sites/default/files/2021-03/ria-tsy-tmmh-mar21.pdf**

if the changes were not made[2] and the overall impact on house prices would be small[3]. A summary of other studies[4] shows mixed results.

Therefore, it is possible that the proposed tax policy of removing interest deductibility to dampen house prices growth may not be realised. Our view is that the solution to housing affordability is structural reform. That is, rather than making tax changes, change planning laws to removing restrictions to release (greenfield) land to increase the supply of land for housing[5].

Current investors

There are many New Zealanders who have acquired residential rental investment properties over many years, with no speculative purpose in mind nor intention to sell anytime soon, or at all. Many of these investors may have placed their life savings into this type of investment to support their retirement, with the plan that ultimately, the property will be debt free and provide a level of passive income to supplement national superannuation entitlements.

For these investors, the bright-line rules are essentially irrelevant – or at least they were up to now – as they had no intention to sell within the bright-line period, they have owned the land since pre bright-line introduction, or their bright-line period has already expired. The removal of interest deductibility is of great significance to these investors, given that the ability to deduct interest expenses against the income earned from the property ensures that, for many, the investment remains affordable. Furthermore, this type of investor provides essential stock to the rental property market and reduces the burden on government in retirement.

Experienced investors have already seen the removal of depreciation deductions which has led to increased tax costs and a reduction in capital improvements to rental properties[6]. The removal of interest deductibility will make investments even more costly and feedback from our members indicates that some clients will have no choice but to sell. For some, not only will a forced sale see the end of their potential retirement nest egg, but for those who have invested since March 2018, they will encounter the added burden of taxation under the bright-line rules, despite never being the "speculator" the Government was targeting when the bright-line rules were introduced.

Therefore, we recommend that the Government consider protecting existing investors who will be impacted out by the proposed changes. An option would be to remove the proposed interest deduction phase-out period, and instead grandfather residential investment properties acquired prior to the Government's 27 March 2021 announcement.

Given that the new build exemption is available for a period of up to 20 years, a similar treatment for existing investors should be made available, as they are already locked into the market supply and should not be retrospectively penalised for their investment decision.

This supports the policy objectives outlined in the Discussion Document, as interest deductions in relation to existing housing stock (**old builds**) will decline over time as either the debt reduces, or the old build is sold. These investors will be incentivised to acquire new builds over old builds going forward, thereby achieving the Government's objective of having reduced the incentive for non-owner-occupiers to invest in old builds.

We submit that interest on post-27 March 2021 borrowings traceable to the old build should remain fully deductible. The old build does not impact market supply post-27 March 2021 and the Government has not stated that it intends to force existing investors to sell their old builds. This will reduce the complexity of the interest limitation rules as the property title register can be used to determine whether a property qualifies for continued interest deductions, removing the need to determine when the borrowings were drawn down. It also removes the complexity associated with revolving credit and other types of variable debt lending facilities that may have been in place with respect to the old build pre-27 March 2021.

We believe that a mechanism linking the interest incurred with both the property itself, and an income producing use of the funds would almost certainly be required. In our view, legislation would need to cope with the increased difficulty in determining interest deductions in certain situations. Examples include where fixed loans have expired, when redraws have happened to fund either private non rental related expenditure or property related expenditure such as renovations, and when a property's use has changed from private to rental. This would need to be addressed by excluding the denial of interest deductions in relation to residential land where:

- the residential land was acquired on or before 27 March 2021, and
- any interest or other financial arrangement deduction satisfies the general permission (i.e. has a nexus to the earning of income).

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[2] Danielle Wood, *Negative gearing changes will affect us all, mostly for the better*, Grattan Institute, 9 February 2019, see link: **https://grattan.edu.au/news/negative-gearing-changes-will-affect-us-all-mostly-for-the-better/** and John Daley and Danielle Wood, *Hot property: Negative gearing and capital gains tax reform*, April 2016, see link: **https://grattan.edu.au/wp-content/uploads/2016/04/872-Hot-Property.pdf**
[3] David Montani, *Negative gearing: separating fact from fiction*, Taxation in Australia, March 2017, p 432-435
[4] Tunny, G., 2018. **Untangling the debate over negative gearing,** Policy, Vol. 34 No. 1, Autumn
[5] Jamies Smyth, Analysis: New Zealand's housing crisis poses big test for Jacinda Ardern, Financial Review, 6 January 2021, see link: **https://www.afr.com/world/pacific/new-zealand-s-housing-crisis-poses-big-test-for-jacinda-ardern-20210106-p56s1v**
[6] Wong, J., Wong, N. and Li, W.Y. (2021), ***COVID-19 and deferred tax reversals***, Pacific Accounting Review, Vol. ahead-of-print No. ahead-of-print, 1 March 2021.

Chapter 2 Residential property subject to interest limitations

We believe that Paragraph 2.54 should not apply because in owner-occupied scenarios the rationale outlined in paragraph 2.52 should flow through to the whole of the land. It therefore becomes irrelevant whether the owner-occupier (who may or may not be a first-home buyer) lets out a room in their own dwelling or in another dwelling that exists on the property. The fact that the land is owner-occupied means that it is no longer in the available supply pool for potential first-home buyers, nor is it in the residential investor supply pool that the Government is targeting.

In these scenarios, it is still a single piece of land that has simply been structurally formatted differently. Permitting a tax deduction for the interest costs where the "tenant" is under the same roof of the owner-occupier, versus denying the same interest cost deduction where the "tenant" is under a different roof on the same owner-occupied land, simply creates a potential taxing bias between two arguably identical first-home buyers.

Income derived from a main home

The proposed approach to income derived from a main home permits interest deductions in the specific instance where the tenant resides in the same dwelling as an owner-occupier. We believe that, for efficiency and consistency, the policy should not distinguish between tenants residing in the main dwelling or a secondary residence on the property. The rationale for the distinction between the main residence and secondary residence on a single owner-occupied property is unclear.

Business premises and dual-purpose buildings on the same title - questions for submitters

- *Would an all-or-nothing predominant use approach for business premises used by the bright-line test be appropriate for interest limitation, or would an apportionment approach be more suitable?*

  In relation to paragraphs 2.64 – 2.69, it is our view that an apportionment approach is more suitable in relation to business premises and dual-purpose buildings.

- *How could an apportionment approach work?*
  - *Should it follow general tax principles, or is there another approach that might be more appropriate?*

    No comment at this stage.

  - *Are there any apportionment calculations regularly done by landowners for other purposes (for example, insurance and mortgages) that might be useful in this context?*

    The apportionment approach should follow general tax principles.

    An all or nothing approach for this type of land use may be appropriate under the bright-line rules where potential application of the business use exclusion only needs to be considered once. However, should there be a disposal of the land within the bright-line period, any costs incurred in relation to holding that land over a period of time should follow the more general tax principles. This includes the application of the likes of a space and time test to determine the deductible and non-deductible components of any expenditure incurred.

- *How might "business premises" be defined for the purpose of interest limitation?*

  No comment at this stage.

  - *To what extent is it possible to reuse the definitions outlined above for this purpose? What issues might this cause?*

    For the purpose of interest limitation, business premises should be defined as being where the premises or part of premises are used, in whole or in part, for the purposes of carrying out business operations, which includes a wide range of activities. Activities include those undertaken in the ordinary course of carrying on a business. They also include those activities that, although not undertaken in the "ordinary" course of carrying on a business, are nevertheless undertaken in the course of carrying on a business.

    Profit making activities that fall short of being a business are also included in ``business operations'' if they have a business or commercial character.

Employee accommodation - questions for submitters

- *Should a carveout for employee accommodation be provided under the interest limitation rules?*

  We agree that a carveout for employee accommodation be provided under the interest limitation rules. When employers build or provide their employees with employee accommodation, they are provided to attract employees moving to be closer to the location of the employer. This is particularly the case for remote locations such as mine sites, where there is a dearth of suitable rental property nearby to meet such demand. Therefore, it makes sense that employers are not be penalised for providing such employee accommodation.

- *Does the employee accommodation carveout in the residential ring-fencing rules provide a useful basis for an interest limitation carveout?*

  Yes, we believe the employee accommodation carveout in the residential ring-fencing rules provide a useful basis for an interest limitation carveout.

- *Can you see any issues with using these rules?*

  Issues may arise where the home is also used as a place of business, such as with small business owners, who are also employees of the business.

- *What integrity issues might arise from carving out employee accommodation, and how could these be mitigated?*

  No comment at this stage.

Student accommodation - questions for submitters

- *Should a specific carveout for student accommodation be provided? Is it necessary?*

  No comment at this stage.

- *Are there any issues with using the regulatory framework in sections 5(1)(h) and 5B of the Residential Tenancies Act 1986 as a basis for this carveout?*

  No comment at this stage.

- *Could a carveout encourage the conversion of regular residential rental properties into student accommodation?*

  - *How could this risk be mitigated?*

    We believe such a carveout will encourage the conversion or labelling of regular residential rental properties into student accommodation.

    The risk could be mitigated by defining premises used to provide accommodation to students in connection with a recognised place of education such as universities, schools and colleges and does not include premises to the extent that they are used to provide accommodation to students in connection with an education institution that is not a place of education.

Short-stay accommodation substitutability issues - questions for submitters

- *Should short-stay accommodation that is not substitutable for long-term accommodation be carved out from the interest limitation rules and why?*

  We believe short-stay accommodation that is not substitutable for long-term accommodation should be carved out from the interest limitation rules on the basis that they are genuinely carrying on a business of providing short-term accommodation.

- *How could this carveout be designed to avoid capturing short-stay accommodation that could be substitutable for owner-occupied housing?*

  To avoid capturing short-stay accommodation that could be substitutable for owner-occupied housing, the IRD will likely require detailed information and documents to determine whether there exists the carrying on a business of providing short-term accommodation. An example of potential requirements is the ATO's guidance on the supporting information required to determine whether a taxpayer is carrying on a business of providing short-term accommodation[7].

- *How could this carveout be designed to prevent short-stay accommodation that is substitutable for owner-occupied housing from being converted so that it is not substitutable?*

  No comment at this stage.

- *How could a carveout be designed to reflect a sense of commercial scale akin to a hotel or motel?*

  No comment at this stage.

Serviced apartments

Responding to the discussion in paragraphs 2.83 to 2.86 regarding serviced apartments, we consider the existing definition of serviced apartment in paragraph (b)(iii) of the Dwelling definition is sufficient to exclude these types of accommodation from the interest limitation rules. The specific need for the apartment owner to show that "paid services in addition to the supply of

[7] ATO, 2020. **Carrying on a business of providing short-term accommodation – supporting information**, Private rulings, ATO advice and guidance, viewed 2 July 2021.

accommodation are provided to a resident" will negate the ability/reduce the incentive for the owner to convert a regular apartment to a serviced apartment, simply to obtain an interest deduction.

For those who do attempt to inappropriately claim a serviced apartment exclusion for what is a regular apartment, existing risk review techniques available to the Commissioner and the Commissioner's ability to deny the expense claims (or at least put the onus back on the taxpayer to prove their tax position) should be sufficient. Having a specific carve-out, which still requires a level of interpretation by the taxpayer, simply adds complexity to the rules.

Māori collectively-owned land - questions for submitters

No comment at this stage.

Chapter 3 Entities affected by interest limitation

Companies - questions for submitters

The Government invites submissions on the proposals outlined above and is particularly interested in:

- *Does treating new builds and residential property covered by the development exemption as "residential investment property" for purposes of the "residential investment property-rich" threshold cause issues for any developer companies? If so, what are those issues?*

  No comment at this stage.

- *Do you prefer to use accounting or tax book values for calculating the residential investment property percentage for assets other than land, improvements and depreciable property? Why?*

  The use of tax book values for calculating the residential investment property percentage for assets other than land, improvements and depreciable property is preferred. This reduces the need to keep two separate set of accounts, i.e. one for accounting purposes and one for tax.

Kāinga Ora - questions for submitters

No comment at this stage.

Chapter 4 Interest allocation: how to identify which interest expenses are subject to limitation

Tracing - questions for submitters

- *Do you agree with the proposed approach to generally rely on the existing law on tracing, except where it would cause transition issues? (Transition issues are discussed at paragraphs 4.17 to 4.40.)*

  The tracing approach is the most obvious way to determine deductibility but may pose challenges for some taxpayers. Smaller investors may not keep the requisite records or hold the necessary documentation due to them having no prior requirements to do so. To deal with these situations, two approaches are proposed at paragraph 4.21. We suggest that the IRD should consider allowing taxpayers the choice to use either, depending on which is most appropriate.

- *Are there other issues with applying tracing that have not been identified in this discussion document? The Government is interested in issues that are particular to interest limitation, and not issues that already exist more generally.*

  No comment at this stage.

Refinancing - questions for submitters

- *Do you agree that a new loan to refinance a pre-27 March loan would benefit from a specific provision?*

  We agree that a new loan to refinance a pre-27 March loan would benefit from a specific provision to ensure re-financing does not change deductibility of a residential property subject to the proposal.

  With respect to paragraph 4.15, if the only additional borrowings on a refinancing of a pre-27 March loan are the break costs associated with the restructure of the borrower's funding sources when commercially sensible to do so, any interest on this additional lending should remain deductible. This retains the phase-out qualities of the pre-27 March borrowings. Denying the deduction will add unnecessary complexity and compliance costs for the borrower, while retaining deductibility is unlikely to impact the policy.

- *Are there any commercial reasons a loan that is in New Zealand dollars would be restructured to a loan in a foreign currency?*

  As an example, this could be the case for eligible foreign buyers, where accessing funds from foreign lenders are cheaper than from New Zealand lenders.

- *Are there other issues with refinancing that we have not considered?*

  No comment at this stage.

Transition issues - questions for submitters:

The approaches proposed above are aimed at making compliance easier for taxpayers who would otherwise have to apply tracing to pre-27 March loans.

- *Which of the proposed approaches do you prefer?*

  In response to paragraph 4.21, we consider that Option 2: Stacking is the preferred approach as it provides a pragmatic outcome for taxpayers. However, we suggest that the IRD should consider allowing taxpayers the choice to use either stacking or apportionment, depending on which is most appropriate in the taxpayer's circumstances.

- *Do you have any suggestions on how the proposed approaches can be made simpler?*

  No comment at this stage.

- *Are there alternative approaches you would prefer? If so, how would that alternative approach work?*

  No comment at this stage.

High water mark - questions for submitters:

- *Do you agree with the proposed approach to a high water mark?*

We have no concerns with the high-water mark proposal and the subsequent limitation to any additional borrowing.

- *Are there some products that can be excluded (for example, loans that only decrease) or should the high water mark apply to all loans?*

  No comment at this stage.

- *Are there any situations when a portfolio basis for a high water mark could be necessary?*

  No comment at this stage.

- *Are there other issues with applying a high water mark that have not been considered above?*

  No comment at this stage.

- *Are there other products that raise issues that are not addressed by the high water mark proposal?*

  No comment at this stage.

Foreign currency loans

With respect to paragraph 4.42, we are of the view that pre-27 March loans in foreign currency should be afforded the same phase-out treatment as pre-27 March New Zealand dollar (**NZD**) loans. The calculation of the interest component each income year remains unchanged under the present proposals which allows for a simple reduction of the interest amount calculated by the applicable limitation percentage.

Where the foreign exchange movement is greater than the interest cost under the arrangement, limiting the resulting net financial arrangement would limit not only deductions but also income. A potential remedy would be to only limit net negative financial arrangements. However, from a tax design perspective, this would be an unbalanced outcome.

Chapter 5 Disposal of property subject to interest limitation

Implementing anti-arbitrage provisions - questions for submitters

Below are questions the Government is posing to help focus discussion, though comments on all aspects of these proposals are welcome:

- *Which option for the treatment of interest on sales of revenue account property best balances housing market incentives, efficient and fair taxation, and protection of the tax base against arbitrage risk?*

  In response to the discussion in paragraphs 5.10 – 5.27, Option B is favoured, as deductions are allowed and deferred to the point of sale. Although, Option B may be enhanced with a modification that, upon the taxpayer triggering a re-characterisation of the land to being held on revenue account (for example, they commence a subdivision of land within ten years of the date of acquiring the land), the interest costs from that point forward are immediately deductible, with a wash-up calculation in the year of disposal for any interest costs incurred prior to the taxing trigger date.

  A modified Option B ensures that existing tax principles are retained, permitting a deduction for all costs incurred by the taxpayer in relation to a sale of revenue account property. It would also cover those scenarios where the development exemption will not have application, for example, the subdivision of land where the bare land titles will be sold as opposed to the land being developed further with "new builds" erected unless the development exemption is intended to cover scenarios where the taxpayer is in essence providing new bare land to the market upon which "new builds" can be constructed.

- *Should the bright-line anti-arbitrage provision be extended to sales taxable under section CB 6 (purchased with the intention of resale)?*

  No comment at this stage.

- *Should some interest deductions be allowed when property is sold on capital account?*

  In response to the discussion in paragraphs 5.28 to 5.33, Option F is favoured, as this methodology would ensure that the net real cost to the taxpayer (i.e. costs in excess of any untaxed gain) is deductible.

- *What are the trade-offs in considering housing market objectives and tax policy efficiency and equity objectives?*

  The Government's approach to achieving its housing market objectives adversely impacts tax policy efficiency and equity objectives. As previously stated, we believe that structural reforms to enhance housing supply will be more effective than introducing tax distortions into the housing market and increasing the administrative and compliance burden associated with the new rules. In that sense, we do not consider that there are trade-offs between the objectives, but rather that the proposed tax changes will lead to inefficient, inequitable and ineffective outcomes with respect to attempting to resolve the stated growing housing crisis.

  The changes canvassed in this Discussion Document will unduly complicate our tax system and introduce a number of potential tax issues. The Government should consider whether other alternatives are better in attempting to tackle, for example, whether to potentially remove planning restrictions to increase the supply of (greenfield) land to build houses instead.

- *How could anti-arbitrage provisions be incorporated? Do you have any preferences between amending the bright-line anti-arbitrage rule to incorporate interest, or the residential rental loss ringfencing rules to incorporate a revenue account loss? Do you have another approach to suggest?*

  No comment at this stage.

Chapter 6 Development and related activities

Questions for submitters

Comments on all aspects of the proposals are welcomed. Below are several questions officials would specifically like to seek feedback on from submitters:

- *Are there other types of developments or activity which should be covered under this exemption?*

  No comment at this stage.

- *Should land dealers (who are included under section CB 7) be carved out from the proposed section CB 7 safe harbour?*

  No comment at this stage.

- *Do you agree with the proposed criteria for the development exemption to apply?*

  No comment at this stage.

- *Should remediation work be included? If so, what types of remediation work should be included? If some remediation work is included, how would this relate to the new build exemption? How does partially including remediation work impact heritage buildings?*

  No comment at this stage.

- *When should interest begin to be deductible when property is not acquired for the purpose of development, but that intention is formed later?*

  In response to the discussion in paragraph 6.25, we believe that the timing of the development exemption commencement should be at the point the relevant taxing provision is triggered – for example, where the relevant taxing provision is section CB 12, the development exemption would apply from the date the scheme or undertaking is deemed to commence under existing taxation principles. This often would be at the time the first overt act to actually progress the proposed subdivision occurs; e.g. the filing of a resource consent application.

- *What is the amount of interest on debt that should qualify for the exemption when property was not acquired for the purpose of development, but development activity commenced some time later?*

  No comment at this stage.

Chapter 7 Definition of new build

Questions for submitters

Comments on all aspects of the proposals are welcomed. Below are several questions that the Government would specifically like to seek feedback on from submitters:

- *What do you think of the proposed definition of new build?*

  We agree with the IRD's definition. We support the inclusion of office conversions to apartments as we believe this is going to be an area of growth for B and C grade office blocks that have high vacancy rates post-COVID.

  There is some concern about a new build requiring a kitchen and bathroom. We understand that it is common for a family to erect a dwelling as a "granny flat" or "sleepout" without either a bathroom or kitchen.

  We believe that student accommodation and serviced apartments should also be included in the definition of a "new build".

  Remediation of "leaky buildings", along with earthquake strengthening, do not appear to be mentioned. We believe they should be included in the exclusion. These are considerable costs to investors, and both are done to maintain an asset.

- *Are there any issues that you think the Government should consider in relation to the definition of new build and:*

  - *papakāinga housing?*

    No comment at this stage.

  - *heritage buildings?*

    No comment at this stage.

- *Is there some tool that could be used to identify when a dwelling that is completely uninhabitable has been improved significantly, such that it has added to housing supply?*

  No comment at this stage.

Chapter 8 New build exemption from interest limitation

Questions for submitters

Comments on all aspects of the proposals are welcomed. Below are several questions that the Government would specifically like to seek feedback on from submitters:

- *Should the new build exemption apply only to early owners, or to both early owners and subsequent purchasers?*

  From the perspective of a newly built property, we are of the view that the new build exemption should be for a fixed period for both the early owner and subsequent purchasers.

  In response to the commentary in paragraphs 8.9 to 8.21, it is submitted that the new build exemption should apply to both early owners and subsequent purchasers. With respect to subsequent purchasers, this would avoid depressed prices for those early owners who, via their investment in new builds, have assisted the Government in achieving its objective of increasing the supply of residential accommodation, but are then disadvantaged when coming to sell because the prospective purchasers cannot obtain the same concessions (as they are focused on new builds only).

  Also, we recommend that the new build exemption period should be 20 years. A longer period would encourage longer continuity of ownership periods due to the retention of interest deduction concessions. This is in contrast to owners looking to sell shortly post the expiry of the relevant bright-line period, potentially flooding the market with old stock as they look to acquire another new build. The impact of the latter behaviour could be upward price pressure on new builds, resulting in new builds becoming less affordable to first-home buyers, whose only option is to acquire old stock.

- *What application period for the exemption do you think best achieves the objective of incentivising (or not disincentivising) continued investment in new housing? The options are: in perpetuity for an early owner only; in perpetuity for an early owner and for a fixed period for subsequent purchasers; or for a fixed period for both the early owner and subsequent purchasers.*

  From the perspective of qualifying for a new build, we submit that the new build exemption should be for a fixed period for both the early owner and subsequent purchasers.

- *Are there any issues that specifically relate to the new build exemption and:*

  - *papakāinga housing?*

    No comment at this stage.

  - *heritage buildings?*

    No comment at this stage.

  - *the purpose-built rentals sector?*

    No comment at this stage.

- *How should the new build exemption from the interest limitation rule apply where interest relates to both a new build and a non-new build? Do you agree with the proposed approach (which would require apportionment rules to be applied), or do you prefer an alternative approach (such as requiring separate title or applying a predominant test)? (Refer to paragraphs 8.27 to 8.29 for more information).*

  Given that the residential rental excess deduction rules already quarantine any excess expenditure (including interest costs) over rental/land sales income (which itself has already created a disincentive for investors to buy residential land), and to remove some of the complexity of the new rules where it is clear that a new dwelling has been added to the land (consequently addressing supply issues), we suggest that interest deduction entitlements be permitted to continue in full rather than having to undertake apportionment calculations for "complex new builds".

  With respect to paragraph 8.29, and as stated in submission 13, our preference would be to have no interest apportionment requirement where it can be shown that a new build has been added to the land. However, if this approach is not taken, then a predominant test should be applied. This would require apportionment of any interest deduction only where less than 50% of the land area is covered by the new build. Otherwise 100% deductibility should remain.

- *Do you have any suggestions for simple ways to prove that a person qualifies for the new build exemption, or ways that Inland Revenue could use existing data to check eligibility?*

  No comment at this stage.

- *What issues might result from relying on CCCs to verify that a person (and their land) is eligible for the new build exemption? Are there particular integrity issues the Government needs to consider?*

  No comment at this stage.

- *What could be used to verify that a person who acquires a property off the plans is eligible for the new build exemption, if that person wants to deduct interest before a CCC is issued?*

  No comment at this stage.

- *How practicable is the continued investment rule (described from paragraphs 8.22 to 8.26)? Do you think the rule is a good idea (considering the criteria mentioned in paragraph 8.26)?*

  In response to the discussion in paragraphs 8.22 to 8.26, and if interest deductibility is made available beyond the first owner, we suggest that the proposed continued investment rule should be dropped. It creates unnecessary complexity to the rules, requiring some sort of mechanism (easily accessible and up to date) to enable a subsequent purchaser to ascertain whether the new build they are considering acquiring has ever been owner-occupied.

  With the dwelling already having satisfied the new build criteria, its subsequent use during the new build exemption period should be irrelevant, with existing tax rules dictating the entitlement to claim interest deductions based on the use of the property over the new build exemption period. The residential rental excess deduction rules would then potentially require quarantining the interest claims in an event where costs exceed land-related income in the relevant year.

Chapter 9 Five-year bright-line test for new builds

Questions for submitters

Comments on all aspects of the proposals are welcomed. Below are several questions that the Government would specifically like to seek feedback on from submitters:

There are several scenarios highlighting adverse application of the bright-line test.

1. Land held in a family for many decades, where they have undertaken a very low-cost subdivision of some land into lifestyle blocks, will be impacted by the bright line because of a minor intervening restructure.
2. Land held by an individual for decades, which is transferred into a deceased estate and then has a very minor subdivision and sale, will be impacted by having no cost to deduct.
3. Bare land owned by an individual who is diagnosed with a serious medical condition, and who sells the land, will be impacted by bright lines as the land is zoned as residential.

   In response to discussion at paragraph 9.7, it is submitted that the five year bright-line test for new builds should apply to both early owners and subsequent purchasers. The Government has repeatedly promoted to the community that the bright-line rules were introduced to deal with so-called “speculators”. If one assumes that an early owner who holds a new build in excess of the requisite five year bright-line period is no longer a “speculator” and consequently should not be subject to taxation under the bright-line rules, then there appears to be no justifiable, rationale reason for not applying the same considerations to subsequent purchasers.

- *Are there any issues that specifically relate to the new build bright-line test and heritage buildings?*

  No comment at this stage.

- *How should the new build bright-line test apply to complex new builds (where a new build and non-new build are on the same title)? Do you agree with the proposed approach, which would require apportionment rules to be applied, or do you prefer an alternative approach (such as applying a predominant test)?*

  With respect to paragraphs 9.10 to 9.13, it seems overly complex to expect an apportionment rule to apply for the purpose of the bright-line test for “complex new builds”. As previously noted in relation to the interest limitation apportionment proposals, an owner of land who has positively addressed the Government’s residential accommodation supply concerns should obtain a full concession in relation to the land upon which a new build is erected, regardless of any existing structures on that same land.

  Consequently, we believe that no apportionment calculation requirement should be triggered in relation to “complex new builds”. The whole of the land would be then subject to the five year bright-line rule. If this is not done, then a predominant test approach should apply instead.

- *Are there any simple ways to prove that residential land a person owns qualifies for the new build bright-line test?*

  No comment at this stage.

- *Are there issues with relying on CCCs to verify that a property is eligible for the new build bright-line test? Should special rules apply if a CCC for a new build is not issued until some years after construction finishes?*

  No comment at this stage.

Chapter 10 Rollover relief

In relation to the commentary in Chapter 10, we recommend that section CB 15(2) be amended to apply to section CB 6A, so that in any associated person transfer, the transferee simply steps into the shoes of the transferor, and is therefore able to take advantage of any time period that the land has already been owned by the transferor. Consideration should be given to the present associated person definitions which apply for the purpose of the land provisions, to ensure that these are adequately drafted to achieve the intent of the roll-over relief concession.

The failure to treat all associated persons' land transactions in an identical manner creates potentially unfair and inappropriate outcomes, in particular where there are minor family restructures or similar. The divergence in rules increases complexity, especially on compliance and disputes.

We observe that the proposed rollover relief introduces a number of new concepts that are complex and unnecessary. A straightforward extension of the existing associated persons provisions applicable to land transactions, to the bright-line provisions, would be a seemingly straightforward way to address such matters. We believe that this change would still allow the appropriate outcomes to be achieved in the examples within Chapter 10.

Transfers on death – questions for submitters

- *Should rollover relief from interest limitation be provided for transfers on death?*

  We agree that rollover relief from interest limitation should be provided for transfers on death.

  We note that the transfer on death provisions at paragraph 10.42 specifically do not address an equitable outcome where land is not residential land when transferred upon death but becomes residential land to the estate. Having been acquired from an associated person, the appropriate outcome is that the estate should not be taxed in a manner that is different from the way the deceased person would have been taxed. Extending the associated persons provisions to apply to the bright-line test would achieve this.

- *If rollover relief is provided for properties subject to the new build exemption on death of an owner, does there need to be a time limit on the availability of relief?*

  The time limit should be the remaining time left under the new build exemption after the transfer of the investment property to the executor/administrator of the estate or beneficiary, whichever is earlier.

Trusts – questions for submitters

- *In your view, are the conditions proposed at paragraph 10.57 appropriately targeted at the most common family trust situations? Are there any alternative criteria that you would suggest?*

  No comment at this stage.

- *What number of degrees of blood relationship should be permissible to determine whether a beneficiary is associated with the principal settlor?*

  We submit that, in determining whether a beneficiary is associated with the principal settlor, the degrees of blood relationship be as follows:

  The settlor and all of the following (if applicable):

  - any parent, grandparent, brother or sister of the settlor or the settlor's spouse

Māori collectively-owned land - questions for submitters

No comment at this stage.

Chapter 11 Interposed entities

Questions for submitters

- *What do you think of the interposed entity rules proposed above?*

  No comment at this stage.

- *In your experience, how common are interposed entities in the residential investment property context?*

  Interposed entities are common for some scenarios of residential investments. This is driven by a number of advantages in having an interposed closed trust, including:

  - The primary beneficiary can claim the interest deductions in their personal tax return.
  - As the asset is acquired in a trust, it is substantially protected from any claims against the primary beneficiary.
  - Any capital gains that are made can be distributed to a wide class of beneficiaries and do not have to be included in the assessable income of the primary beneficiary who makes the stakeholder loan, provided they have recouped all the interest paid to the bank.
  - Because the net income of the trust could be significantly less than the interest payable to the bank in the early years, the primary beneficiary will get a tax deduction for substantially all of the interest payable on the bank loan

- *What are some of the commercial reasons why, for close companies, taxpayers may prefer to have their borrowing at the shareholder level instead of the entity level?*

  No comment at this stage.

- *Do you prefer to use accounting or tax book values for calculating the affected assets percentage for assets other than land, improvements and depreciable property? Why?*

  The use of tax book values for calculating the affected assets percentage for assets other than land, improvements and depreciable property is preferred. This reduces the need to keep two separate set of accounts, i.e. one for accounting and one for tax.

- *What is your preferred frequency for the apportionment calculation for interposed entities that are close companies or trusts - daily, monthly, quarterly, annually?*

  No comment at this stage.

- *Do you agree that the proposed interposed entity rules should not be applied to LTCs or partnerships?*

  No comment at this stage.

- *Are there any commercial reasons why a taxpayer might borrow funds and on-lend them to an interposed company at a lower interest rate?*

  No comment at this stage.

Chapter 12 Implications for the rental loss ring-fencing rules

Questions for submitters

Below are several questions the Government would specifically like feedback on from submitters:

- *How should the interest limitation rules be aligned with the loss ring-fencing rules?*

  No comment at this stage.

- *Is the proposed approach of applying the interest limitation rules to establish deductible expenditure and then applying the RLR rules to this deductible expenditure an effective means of addressing this?*

  No comment at this stage.

- *Are there other interface issues between the rules that we have not addressed?*

  New Zealand tax residents who hold financial arrangements are required to apply the accrual or cash basis rules when their financial arrangements involve a deferral of the payment of consideration. This applies regardless of whether the financial arrangement is held in New Zealand or offshore.

  Examples of such deferral of payment of consideration in an offshore context include:

  (1) A mortgage denominated in a foreign currency to buy a rental property regardless of where the rental or mortgage is situated; and

  (2) An ordinary foreign currency bank account.

  The financial arrangement rules disregard the distinction between capital and revenue amounts, and a holder of such financial instruments might be required to spread income and expenses over the term of the arrangement. A cash basis holder does not have to use a spreading method and is able to report income or expenses on a cash basis.

  A person can only be a cash basis person when certain thresholds are not breached. These thresholds have not been amended for some time. This means that, over the years, more individuals have been pushed out of the application of the cash basis rules. A cash basis holder is required to calculate their taxable income under both the accrual rules and the cash basis rules to ensure that the net deferral amount of $40,000 Is not breached. Therefore, cash basis holders have a relatively higher compliance cost than accrual rules holders.

  In substance, the financial arrangement rules in a cross-border transaction are a capital gains tax as the New Zealand holder of such financial arrangements is taxed on the net wealth increase/decrease. The taxable income can be calculated either under the determination G9A (market-to-market) or the determination G9C (expected value). G9C requires the holder of the financial arrangement to make an election within a certain time frame to apply this determination. A returning resident or new migrant to New Zealand will not have the requisite knowledge to make an election 63 days after they ceased to be a transitional tax resident. The low deferral threshold and the complexity of the rules potentially create an environment of non-compliance.

  As at 31 March 2020 many exchanges rates strengthened against the NZD. This has had a significant impact on New Zealand tax residents with offshore investments (assets and liabilities). For example, the Euro exchange rate moved from 0.6068 on 31 March 2019 to 0.5400 on 31 March 2020. This weakening of the NZD against the Euro will trigger significant book profits for assets denominated in Euro which are financial arrangements and significant book losses for liabilities denominated in Euro which are within a taxable activity (rental income).

  The foreign exchange loss from a foreign mortgage will form part of excess deductions in the year ending 31 March 2020 (assuming there is an overall loss) as it forms part of the interest deduction. The strengthening of the NZD against the Euro in the following income year (31 March 2021) will mean the book losses are effectively reversed, and the foreign exchange loss will not be able to be offset, as it is not residential income. This means the New Zealand tax resident will have a ring-fenced loss and a fully taxable recovery of the interest income from the foreign exchange profits.

- *How should we integrate interest limitation, ring-fencing, and bright-line anti-arbitrage rules?*

  No comment at this stage.

Chapter 13 Interest limitation and mixed-use residential property

Questions for submitters

Below are several questions the Government would specifically like feedback on from submitters:

- *How commonly are residential property MUAs held in close companies?*

  No comment at this stage.

- *How commonly are residential property and other MUAs held in the same close company?*

  No comment at this stage.

- *How do companies currently deal with the conflict between the MUA interposed entity rule and the RLR interposed entity rule, where they own both an interest in a close company with a MUA and a close company with a residential property subject to the RLR rule?*

  No comment at this stage.

Chapter 14 Administration

The proposed changes introduce tax complexities into the residential housing market. If introduced, tax advisers will be critical to successful implementation and ongoing integrity. We anticipate that interpretation and guidance material from the IRD will be required and recommend that an educative approach is taken to compliance with these rules in the first years.

Where carve-outs and exemptions are available, IRD guidance on record-keeping will reduce uncertainty. We recommend that record-keeping requirements are designed in consultation with advisers and investors so that they are practical and less costly to implement. The IRD should also seek to leverage records that are already usually kept for non-tax purposes and to utilise data already held by government.

Questions for submitters

The Government is seeking feedback on the following:

- *Are there issues with adding new fields to income tax return forms for total interest incurred in relation to land used for income-earning purposes and the amount of this interest that has been deducted?*

  We do not see any issue with adding new fields, including fields for total interest and allowable interest. In Australia, the ATO requires details of rental income and expenses, including interest on loans, in its **rental property tax schedule**.

- *What data points might Inland Revenue be able to use to verify that a person qualifies for the new build rules?*

  No comment at this stage.

- *What records should taxpayers have to provide or keep in order to show that they are eligible for the new build rules?*

  No comment at this stage.

- *Are there issues with relying on CCCs to determine whether a property is a new build? Are there integrity issues the Government needs to consider?*

  No comment at this stage.

- *If there are problems with relying on CCCs, what else could be used to verify that a property is a new build?*

  No comment at this stage.

- *What information could subsequent purchasers use to determine that a property they have acquired is eligible for the exemption for new builds from the proposed interest limitation rules?*

  The vendor would need to apply to the relevant building authority and provide the purchaser with a new build exemption certificate.