Tax Tips Alert | October 2021

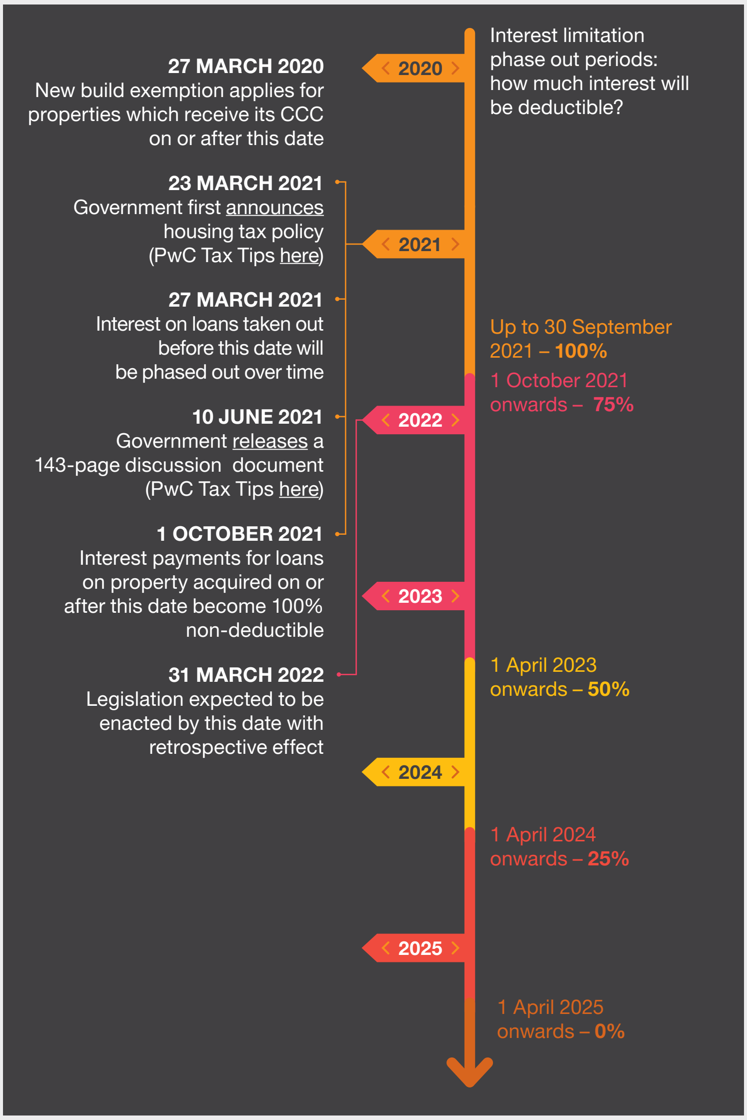
Government introduces housing tax changes

This week, the Government unveiled the details of its controversial tax response to housing affordability in a Supplementary Order Paper (SOP) to the Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Bill (the Bill).

Background

The Government has proposed tax rules which are intended to address New Zealand's "long-standing housing affordability problem" and bring about more owner-occupied housing, sustainable house prices, and a more competitive housing market. At a high level, it is proposed that interest deductions in relation to residential investment properties will be disallowed (with deductions for interest on existing loans to be phased out over time).

The final details released this week further demonstrate that the rules will be complex to apply. However, there were a number of positive policy decisions which were taken on board by officials as part of the consultation process. We have set out below the key design decisions which have now been confirmed by the SOP.



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The Bill: key policy decisions

Properties subject to the rules

Consistent with the Government's stated housing policy objectives, the rules are intended to apply only to properties which someone can live in as a dwelling (for example, business premises are proposed to be excluded from the rules). Further, the Government has maintained that the main home will not be subject to the rules. While there is an existing definition of "residential property" for tax purposes, a number of boundary issues were identified as part of the consultation process and the proposals have provided some further certainty as to the kind of properties which should be excluded. The excluded properties are generally those that are unsuitable for use as long-term accommodation:

- **Main home**: generally, interest expenses in relation to a person's main home are not tax deductible as it is private expenditure. However, if a portion of a person's main home is used to earn income (e.g. flatmates), this portion of the interest will remain deductible.
- **Business premises**: to the extent that all or part of a residential property is used as business premises (e.g. a home office or a shop), interest will continue to be deductible in relation to the business use of the property.
- **Certain Māori land** (including papakāinga and kaumatua housing, and land transferred under a Te Tiriti o Waitangi settlement).
- **Emergency, transitional, social, and Council housing**: community housing providers are generally exempt from income tax and should be unaffected by the proposals. However, to the extent that emergency, transitional or social housing is provided by a taxpaying entity to a community housing provider or a government department, interest will continue to be deductible.
- **Commercial accommodation**: for example, hotels, motels, hostels, inns, campgrounds, etc.
- **Care facilities**: such as hospitals, hospices, nursing homes, and convalescent homes.
- **Farmland**
- **Retirement villages and rest homes**
- **Employee accommodation**
- **Student accommodation**
- **Land outside New Zealand**: is excluded on the basis that they do not have an effect on New Zealand's housing market.

Who is excluded from the proposals?

It is proposed that the rules will not apply to most companies whose core business does not involve residential land. This will be determined by reference to a formula where residential property (including new builds) makes up less than half of their total assets. However, close companies (i.e. companies where five or fewer individuals or trustees own more than 50% of the company) will be subject to the proposed rules. Further, property developers and Kāinga Ora (and its subsidiaries) will also be excluded from the rules.

Property developers

The Government initially proposed that property development activities would not be subject to the rules. Following feedback received from consultation as to the way in which property developers acquire, hold, and develop property, a further exclusion is proposed in relation to land that is held as part of a developing, subdividing, constructing, or land-dealing business.

The development exemption initially proposed in relation to the development activities themselves will also apply, from the date when the activities commenced to when a Code Compliance Certificate (CCC) is issued in relation to the property. From that point on, the "new build exemption" will apply. Note that this exemption applies even if the person is not a property developer with the focus being on the activity that is being undertaken.

New builds

To facilitate the supply of new housing, new builds will be exempt from the proposed rules. Further, new builds will be subject to a 5 year bright-line period under the bright-line test (which is shorter than the new 10 year bright-line period which began to apply from 27 March 2021). A "new build" will generally be defined as a self-contained residence that receives a CCC confirming the residence was added to the land on or after 27 March 2020. Interest relating to remediation work done to an existing property that is significant enough to create a new build will also qualify for this exemption.

The new build exemption applies from when it receives its CCC, or when it has been acquired (e.g. if it is acquired "off the plans"). The new build exemption applies for a period of 20 years after it receives its CCC. The exemption will apply to anyone who owns the new build within this 20 year period, and the timing of the exemption will not reset when the property is sold.

Interest subject to the rules

Under these proposals, tax deductibility depends on the use of the money, not the collateral against which the debt is registered. Given money is fungible, this presents challenges in determining exactly how the debt should be allocated, where taxpayers have both residential property and any other business assets.

The SOP proposes a "stacking" approach whereby taxpayers allocate loans first to assets that are not residential investment properties based on the market value of assets at 26 March 2021. The stacking method recognises that taxpayers could structure their borrowing differently to achieve the same outcome as under the stacking approach, therefore maximising the amount of deductible interest.

Deduction on disposal

The SOP proposes to allow a deduction for otherwise disallowed interest on disposal of the property, if the amount received on the disposal is treated as income under the bright-line test. However, the interest deductions will be ring-fenced so that it may only be applied against residential property income (e.g. the proceeds of the disposal or rental income from other properties).

Rollover relief

The June discussion document proposed relief where there was a legal change in ownership of the land, but no economic change (for example, property transferred to family trusts, look-through companies and partnerships). Without a concession, the transfer would trigger the bright-line test or disentitle the taxpayer to the transitional interest deductibility rules. However, the SOP includes rules which are intended to allow transfers of residential land to look-through companies, partnerships, trustees and Māori authorities to treat the acquisition date as that of the transferor.

Anti-avoidance measures

The Government is concerned that it may be difficult to distinguish between interest deductions incurred for different income-generating purposes, and that the proposed rules may give rise to revenue integrity issues. For example, taxpayers are generally allowed an interest deduction in respect of loans used to acquire shares to the extent the taxpayer earns income from holding that interest (e.g. dividends). This could have resulted in taxpayers structuring their investments in residential property via a company in order to access interest deductions. To counter this, specific anti-avoidance measures are proposed.

For example, one anti-avoidance measure relates to “interposed residential property holders”. This definition includes close companies and trusts with a “residential property percentage” of more than 10% (for other interposed entities, the threshold is 50%). The concept of a “residential property percentage” is relevant for determining how much interest is denied, and is calculated by reference to “disallowed assets” (i.e. the value of the person’s property that is subject to the interest limitation rules) divided by the value of the person’s total assets.

Specific anti-avoidance measures are proposed to apply in circumstances where a taxpayer’s action has the purpose or effect of defeating the intent and application of the rules. Any effect of that action on the “residential property percentage” is disregarded.

Foreign currency loans

We are pleased to see that the bill will ensure symmetry by treating income from hedges on foreign currency loans as exempt income. This means taxpayers will not be taxed on movements in the value of the loan and simultaneously be unable to deduct interest in respect of the loan.

PwC view

The tax policy settings for residential housing have been subject to significant changes in recent years (for example, extensions to the bright-line test and the residential rental loss ring-fencing rules). This next tranche in particular introduces a number of highly complex concepts, and when viewed in totality, it will be complicated to work through the interaction between these various regimes. In our view, these rules will erode the coherence of the tax system. It is difficult to reconcile the proposed changes with the broad consensus on tax policy principles that has emerged over the last 30 years (i.e. the broad-base, low-rate framework), which has broadly held that the tax system should treat different classes of investments equally so as not to distort investment decisions (i.e. horizontal equity).

These proposals are likely to influence investment decisions in the residential housing context (i.e. by reducing investor demand). However, officials appear to be divided on whether the rules will be effective in achieving housing affordability. Meanwhile, we are concerned with the possible unintended consequences of the proposals on both the tax system and the housing market.

We also have concerns regarding the speed with which the proposed rules will be implemented. The rules will become effective from this Friday, 1 October 2021, once they are retrospectively enacted by Parliament in early 2022. Although we appreciate officials’ efforts to design the rules within this short timeframe, we consider that a longer timeframe to implement the policy is warranted to provide certainty to affected taxpayers, particularly given the significance of the proposed changes. We expect that further remedial legislation may be required to address issues which were not able to be resolved in the current timeframe.

What's next?

The SOP will be referred to the Finance and Expenditure Select Committee (FEC), which has called for public submissions on these proposals alongside the other proposals contained in the Bill. There will be a six week consultation period which ends on 9 November 2021. This should provide an opportunity to provide input into further refinements to the proposed rules.

In particular, we note the Minister of Housing and Urban Development's comments that further consideration will be given to the position of "build-to-rent" (BTR) developments under the proposed rules. BTR is a growing sector in New Zealand which fills an important gap in the housing market. In our view, consideration should be given to special rules for large-scale BTR developments as these will be an important contributor to increasing housing supply. Further, transitional relief should be considered for BTR developments which may fall just outside of the proposed new build period so as not to penalise "first movers" in this space. The Minister has signalled that an extension beyond the 20 year period for new builds may be proposed in relation to BTR developments. We welcome further developments in this area.

Other tax changes in the SOP

Business continuity test: A remedial change has been included to ensure that tax losses incurred in the income year of a breach will be available to be carried-forward under the business continuity test.

New alternate FBT rate: A new option for calculating fringe benefit tax (FBT) will be available from the 2022 income year, meaning employers would pay FBT at:

- 49.25% for all employees with "all-inclusive pay" under $129,681, and
- 63.93% for employees with all-inclusive pay of $129,681.

Contact us

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