

Design of the Interest Limitation Rule

Since my last newsletter, Inland Revenue has helpfully issued a set of questions and answers that are designed to assist understanding of the interest limitation rule for residential investment properties. A selection of the questions and answers, in some cases coupled with my commentary on them appears below. In any event, as the intended commencement date is 1 October, draft legislation confirming the scope and operation of the interest limitation rule can be expected soon.

Q. How will interest limitation affect purpose-built rentals?

A. There are no specific proposals in the discussion document regarding the purpose-built rental sector. However, the development exemption (if applicable) and new build exemption will both apply to purpose-built rentals.

Q. Why is an exemption being considered for property taxed on sale?

A. It's a question of fairness. One of the intentions behind the denial of interest deductions for residential investment property is to reduce a current tax advantage for property investors due to all interest being deductible while gains on sale are often not taxable. But where the property is taxed on disposal, not allowing deductions would represent over taxation of income.

Comment: The paper goes on to say,

"Full denial of deductions remains an option as that would have the strongest impact on the housing market".

Tax systems target tax symmetry by matching deductibility for expenditure with the accessibility of the corresponding item of revenue. It is understandable that an interest deduction will be denied for borrowings applied in purchasing property that produces a non-taxable capital gain. It is an over-reach to deny an interest deduction where the gain on a property is fully taxed.

Q. Why is there an exemption for property development?

A. One of the Government's objections in limiting interest deductibility is to improve the affordability of New Zealand's housing stock. Lowering demand is one aspect of this, however, ensuring ongoing supply is equally important.

Q. Will remediation work qualify for the development exemption?

A. Remediation work undertaken by those in the business of developing property will qualify for this exemption if they hold the property as taxable on sale. We invite

submissions on whether remediation works undertaken by those not in the business of developing property should qualify for the development exemption.

Comment: I believe a deduction should be available for remediation work that targets improved housing standards for tenants, deductibility may motivate landlords to do more than the bare minimum in improving housing standards.

Q. What is a new-build?

A. Generally, a new build would be defined as a self-contained dwelling that receives its code compliance certificate on or after the 27 March 2021, or is acquired on or after 27 March but received its code compliance certificate in the last 12 months.

Q. If I buy a new build that received its code compliance certificate (CCC) before 27 March 2021, am I eligible for the new build exemption?

A. It depends when you buy the new build. If you bought the new build before 27 March 2021, then it is proposed that you wouldn't be eligible for the new build exemption. On the other hand, if you buy the new build on or after 27 March and within 12 months of the new build receiving its CCC, then it is proposed that you would be eligible for the exemption. However, a subsequent purchaser (who acquires the new build more than 12 months after its code compliance certificate is issued) would not qualify for the new build exemption.

Comment: This signals confused thinking. Deductibility will be available for the term of borrowing for an owner if he or she is the first owner (or becomes an owner within 12 months of a CCC being issued), but will be denied for a purchaser of the property where the purchase occurs more than 12 months after the CCC is issued. There is no logic in a 'new build' essentially ceasing to be a 'new build' just because its ownership changes. This creates a tax preference for an initial owner over a subsequent purchase that will affect the marketability of the property, despite its 'new build' character. The paper states that the Government is considering the option of the exemption applying in perpetuity for an initial or early owner and for a fixed period for subsequent purchasers, which may be a solution.

Q. What does rollover relief in the context of interest limitation mean?

A. Rollover relief for interest limitation means disregarding transfers or disposals of residential property in defined circumstances.

Q. What rollover relief is being proposed for interest limitation?

A. As in the case with the rollover relief proposed in relation to the bright-line test, rollover relief for interest limitation is proposed for some dispatch of land to yourself, to a family trust, to a book through company or partnership.

Rollover relief for interest limitation is also proposed where a residential property is transferred upon the death of its owner (that is, from the deceased's estate to a beneficiary of the estate) and where residential property is transferred under a relationship property agreement as part of a company amalgamation.

Q. Why is it proposed that some large companies will not have to apply the interest limitation rules?

A. Large companies will still have to apply the rules if more than 50% of their assets by value are residential property.

As noted these answers will be confirmed with the draft legislation that is shortly forthcoming.

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