Inland Revenue
Te Tari Taake

# Interest limitation and additional bright-line rule

**Ivy Lee**
Technical Specialist

**Ann Shi**
Customer Compliance Specialist

June 2021

Inland Revenue
Te Tari Taake

# Overview

- Recent legislation update
- Proposals on interest limitation

# Recent legislation updates

# Changes to the bright-line test

- 10 Years if acquired on or after 27 March 2021
- 5 years if acquired between 29 March 2018 and 26 March 2021 inclusive
- 2 years if acquired between 1 October 2015 and 28 March 2018 inclusive
- New build bright-line test – new builds acquired on or after 27 March 2021 will be subject to 5 year bright-line test rather than 10 years

# New change-of-use rules for bright-line test

Main home exclusion will no longer apply on an all or nothing basis for the 10-year bright-line rule. There is also a 12 month buffer.

- The 5-year bright-line test has been shifted from s CB 6A to s CZ 39.
- The main home exclusion for the 5-year bright-line test (all or nothing basis) has been shifted from s CB 16A to CZ 40.

Applies to property acquired on or after 27 March 2021.

# Treatment of short-stay accommodation

The definition of 'residential land' has been amended to ensure property used to provide short-stay accommodation, where the property is not the owner's main home, is unable to qualify for the business premises exclusion for the purposes of the bright-line test and the residential loss ring-fencing rules.

- **Bright-line rules** - applies to property acquired on or after 27 March 2021.
- **Residential loss ring-fencing rules** – applies from the 2021-22 income year onwards (regardless of when it was acquired).

# Updated s DB 23 and interaction with the general permission under s DA 1

Recent amendment to s DB 23 clarifies that the cost of the revenue account property is deductible even if it was not known when the costs were incurred that the property would be subject to tax on sale, or if the property was used privately while it was held. The amendment supplements the general permission.

Effective from 1 April 2008.

# Habitual buying and selling of land

The amendments expand the regular pattern restrictions in the main home exclusion, the residential exclusion and the business premises exclusion to apply to regular patterns of buying and selling land by a group of persons acting together.

The amendments will ensure that taxpayers cannot structure around the regular pattern restrictions by using different people or entities to carry out separate transactions, or by varying what is done to the land in each transaction so that there is no ‘pattern’.

Effective from 30 March 2021.

# Interest limitation

# Grandparented interest

- Interest on debt drawn down before 27 March 2021 relating to residential investment property acquired before 27 March 2021.
- Deductions will be gradually phased out:

| Date interest incurred | Percent of interest you can claim |
|---|---|
| 1 April 2020 to 31 March 2021 | 100% |
| 1 April 2021 to 31 March 2022 (transitional year) | 1 April 2021 to 30 September 2021 – 100%<br>1 October 2021 to 31 March 2022 – 75% |
| 1 April 2022 to 31 March 2023 | 75% |
| 1 April 2023 to 31 March 2024 | 50% |
| 1 April 2024 to 31 March 2025 | 25% |
| From 1 April 2025 onwards | 0% |

# Residential property subject to interest limitation

Government’s intention to cover property that is commonly and foreseeably used to provide residential accommodation on a long-term basis.

**Exclusions**

- Houses on Farmland
- Business premises
- Care facilities (such as hospital, nursing home)
- Commercial accommodation
- Retirement villages and rest homes
- Income derived from main home (such as flatmate or border)
- Employee accommodation
- Student accommodation

# Entity affected by interest limitation

- Close company (including LTC).
- ‘Residential investment property-rich’ company.
- Trust.
- Partnership and limited partnership.
- Individuals.

# Interest allocation – Tracing approach

- Nexus with assessable income required.
- How it works?
  - value of the borrowed funds are traced to the value of any asset acquired using those funds or, if the funds have been applied to an expense, the cost of that expense.
- Change of use of the borrowed fund from business to residential – no deduction.
- Pre 27 March loans – High water mark proposal:
  - Step 1 – Determine the high water mark.
  - Step 2 – Adjust loan balance for private and other deductible expenses after 26 March.
  - Step 3 - Determine the amount of borrowing that generates deductible interest subject to phasing.

# Tracing approach example 1

- On 26 March 2021, Darryl owes $500,000 on a revolving credit facility to fund his residential rental property.
- The facility has a limit of $600,000.
- Darryl does not use this account to fund any private expenses of any other deductible uses. His high water mark is $500,000.
- Although the balance fluctuates as he receives rental income and pays expenses, by 30 September 2021, the balance is $480,000.

Provided the balance does not go above $500,000 before the phasing period, Darryl will be able to calculate his interest deduction by multiplying all the interest charged on the account by the relevant phasing percentage.

# Tracing approach example 2

- On 26 March 2021, Darryl owes $500,000 on a revolving credit facility to fund his residential rental property.
- The facility has a limit of $600,000.
- His high water mark is $500,000.
- Although the balance fluctuates as he receives rental income and pays expenses, by 30 September 2021, the balance is $480,000.
- On 1 April 2023, Darryl withdraws $70,000 to buy a car for personal use.
- The loan balance will be increased to $550,000.

The water mark remains at $500,000 but the adjusted loan balance will be $480,000 (excluding the funds used to buy car). The amount of loan allocated to the residential rental property is the lower of the high water mark ($500,000) and the actual balance adjusted ($480,000). The deductible interest will be calculated by multiplying the adjusted loan balance of $480,000 by the interest rate and then apply the phasing percentage. The portion of the loan used to buy car is fully non-deductible.

# Development exemption – Interest limitation

- Applies to any activity that results in a dwelling that qualifies as a new build.
- Exemption is intended to cover:
  - land being developed by persons in the business of developing or dealing land or erecting buildings (captured under s CB 7)
  - other developments which contribute to the creation of a new build, for example, a one-off development or developing properties to rent out themselves (note sufficient nexus is still required).
- Remediation work (feedback is sought) may:
  - apply to work that makes a building habitable or extends its life
  - not be appropriate for renovations that are not substantial.

Inland Revenue
Te Tari Taake

# Development exemption – Interest limitation

Examples of developments that may qualify include:

- building a house
- converting a single house into multiple flats
- converting a commercial or industrial property to a residential property
- relocating a house.

To the extent that the activity is:

- subdivision
- development of land, or
- erecting a building.

# Development exemption – Interest limitation

**Qualifying interest**

- Applies to interest incurred in relation to the acquisition of land.
- Interest incurred on any additional debt acquired for the development activity.

**Timing**

- Applies from the point the development activity begins. For land acquired for:
  - the purpose of development – from when the land is acquired
  - a purpose other than development – from when it begins to be developed.
- Switching from development exemption to the new build exemption once CCCs are issued for the new dwellings.

# New build definition

**Simple new builds**

- Adding a dwelling to bare land.
- Replacing an existing dwelling with 1 or more dwellings.

**Complex new builds**

- Standalone dwelling.
- Attaching a new dwelling to an existing dwelling.
- Splitting an existing dwelling into multiple dwellings.

**Commercial to residential conversion**

**Excludes renovations that do not clearly increase housing supply**

# New build exemption - bright-line test

- Applies to residential land that has a ‘new build’ on it, but only if the land is acquired on or after 27 March 2021.
- 5 year new build bright-line rule ≠ old 5 year bright-line test
    - New main home exclusion applies for the new build bright-line test.
- Only applies to early owners.
- Apportionment for complex cases is proposed. For example when a dwelling is added to residential land that has an existing dwelling on the same title.

# New build exemption - interest limitation

**General rule**

- Only new builds with a CCC issued on or after 27 March 2021 eligible.

**Transitional rule**

- Exception for new builds with a CCC issued before 27 March 2021, if the person acquires the land on or after 27 March 2021, and no later than 12 months after the CCC is issued.

**Proposal**

- 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.

# New build exemption - interest limitation

**Who an early owner is**

a) Acquires a new build off the plans

b) Acquires an already constructed new build no later than 12 months after the new build's CCC is issued

c) Adds a new build to bare land

d) Adds a complex new build to land

e) Completes a commercial-residential conversion.

**When does the new build exemption apply?**

- From the date a CCC is issued for the new build (except for a) and b) above, for which the new build exemption applies from the date of acquisition).

# New build exemption - interest limitation

**Subsequent purchaser**

- A person who acquires a new build more than 12 months after a CCC for the new build is issued.

**When the new build exemption applies**

- From the date of acquisition.

**Who’s eligible and for how long**

- In perpetuity for early owners.
- In perpetuity for early owners and a fixed period for subsequent purchasers.
- For a fixed period for both early owners and subsequent purchasers.

# New build exemption – apportionment requirements

**Where a new build and a non-new build that are on the same title are purchased**

- New build exemption only applies to interest on the portion of the purchase price borrowing that relates to the new build.

**Where a new build is added to land that already has a non-new build on it**

- Interest deduction is allowed for all borrowings incurred to add the new build to the land.
- Interest deductions for borrowings used to acquire the land and other borrowings that relate to both the new build and the existing dwelling must be apportioned.

**If without apportionment**

- Separate title is required for any new build added to land, or
- Predominant test, for example, if more land area is covered by a new build than a non-new build.

# Disposal of property subject to interest limitation

**Question: Should interest be allowed in some cases when a property is sold?**

Property held on revenue account

- Option A – Deductions denied permanently in all circumstances.
- Option B – Deductions allowed and deferred to point of sale.
- Option C – Deductions allowed at point of sale to the extent they do not create a loss.
- Option D – Anti-arbitrage restriction for interest (that is, option C subject to restrictions).

Property held on capital account

- Option E – No deductions allowed (offsetting the benefit of tax free capital gains).
- Option F – No deductions allowed up to the amount of non-taxed gain with the excess deductible.

# Administration

**Options**

- Customers to provide additional information for interest expenses in relation to land used for income-earning purposes.
- Customers to provide evidence to support exemption from interest limitation.
- Rely on existing record keeping rules in the Tax Administration Act 1994.

**Proposal**

- Add new fields to income tax returns for total interest incurred and interest deductions claimed.

# Questions.

Inland Revenue
Te Tari Taake

# Thank you.