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WEEKLY COMMENT: FRIDAY 6 MAY 2022

1. The *Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Act 2022* ("the March 2022 Tax Act"), which received the Royal assent on 30 March 2022, contains the new rules on interest deductibility for residential properties and the corresponding changes to the bright-line test for taxing disposals of residential properties. Inland Revenue issued *Special Report on Public Act 2022 No 10* ("the March 2022 SR") on 31 March 2022 covering the rules limiting interest deductibility and the additional bright-line test rules.

2. I will discuss these rules over the next few weeks. This week I look at the general rules for limiting interest deductions in s DH 8, and meanings of disallowed residential property ("DRP) and excepted residential land.

Interest limitation rules

3. Section 75 of the March 2022 Tax Act inserted a new subpart DH headed "Interest incurred in relation to certain land" into the Income Tax Act 2007. Corresponding amendments have been made as follows:

   (a) Changes to the interest deductibility rules in subpart DB (see paragraph 4 below);

   (b) The insertion of sections CB 6AB, CB 6AC, and CB 6AE which set out the rollover rules for certain residential property transfers, but which also apply to the interest limitations on certain grandparented loans (which will be covered in *Weekly Comment* week-after-next);

   (c) Amendments to sections in subpart DG relating to the mixed use asset rules insofar as they concern residential property mixed use assets (which will be covered in *Weekly Comment* in 3 weeks' time);

   (d) The insertion of s CW 62C to make income from certain foreign currency loans relating to residential property exempt from income tax (which will also be covered in *Weekly Comment* in 3 weeks' time); and

   (e) The inclusion of two specific anti-avoidance rules (which will also be covered in *Weekly Comment* in 3 weeks' time).

4. Section DH 1 states that:

   (a) The purpose of the subpart is to deny a person a deduction for certain interest incurred in relation to certain land, despite any other provision in Part D, and it is worth noting that:

(i) Section DB 7(6C) provides that subpart DH overrides the general interest deductibility permission for companies for interest to which subpart DH applies; and

(ii) Section DB 8 (6C) provides that that subpart DH overrides the permission to deduct interest on money borrowed to acquire shares in group companies for interest to which subpart DH applies;

(b) The provisions of subpart DH override the general permission for deductibility of expenditure in section DA 1.

5. Section DH 2 states the subpart applies to interest incurred on or after 1 October 2021.

6. Section DH 8 contains the general rules for limitation of interest deductions and provides that a person is denied a deduction for interest if, and to the extent to which, the interest is:

(a) Incurred for "disallowed residential property" ("DRP") – see paragraph 9 onwards below, excluding interest for a "grandparented transitional loan" (to be covered in *Weekly Comment* week-after-next);

(b) "Grandparented residential interest" (to be covered in *Weekly Comment* week-after-next), but the deduction denied is limited to the following percentages for the following periods (regardless of a taxpayer's balance date, meaning taxpayers who do not have 31 March balance dates will have to apply different percentages):

(i) For grandparented residential interest incurred from 1 October 2021 to 31 March 2022: 25%;

(ii) For grandparented residential interest incurred from 1 April 2022 to 31 March 2023: 25%;

(iii) For grandparented residential interest incurred from 1 April 2023 to 31 March 2024: 50%;

(iv) For grandparented residential interest incurred from 1 April 2024 to 31 March 2025: 75%;

(v) For grandparented residential interest incurred on or after 1 April 2025: 100%;

(c) Incurred to acquire an ownership interest in, or become a beneficiary of, an interposed residential property holder (to be covered in *Weekly Comment* in 3 weeks' time) – however, for an interposed residential property holder that is a close company, the deduction denied, for an income year, is the following quarterly calculation, summed for the entire income year:

(i) Interest incurred by the close company in the quarter; multiplied by

(ii) The interposed residential property percentage for the close company, calculated under s DH 6 at the end of the quarter;

(iii) **Note:** the above is just an overview – interposed residential property holders will be covered in detail in *Weekly Comment* in 3 weeks' time;

(d) Incurred to refinance a loan, interest for which is described in (a) or (c) above;

(e) Incurred under a loan in foreign currency, in which case, the above exception for grandparented residential interest and the above close company quarterly deduction denial limits will not apply – i.e. s DH 9 states that all interest under loans denominated in foreign currencies for DRP will be disallowed.

7. The application of these rules to the following will be covered in *Weekly Comment* in 3 weeks' time:

   (a) Companies;

   (b) Interposed entities; and

   (c) Mixed use assets.

8. There are a series of exemptions set out in s DH 4, which will be covered in next week's *Weekly Comment*, for:

   (a) "New builds" ("new build exemption") in s DH 4(1);

   (b) Business relating to land under s CB 7 ("land business exemption"), in s DH 4(2);

   (c) Development, division or building for the purpose of creating new build land ("development exemption"), in s DH 4(3);

   (d) Social, emergency, transitional, and support housing, in s DH 4(4);

   (e) Council housing, in s DH 4(5); and

   (f) Kainga Ora-Homes and Communities and wholly-owned subsidiaries, in s DH 4(6).

Disallowed residential property (DRP)

9. "Disallowed residential property" ("DRP) is set out in s DH 5(2) as meaning land in New Zealand to the extent to which:

   (a) It has a place configured as a residence or abode, whether or not it is used as a place of residence or abode, including any appurtenances belonging to or enjoyed with the place;

   (b) The owner has an arrangement that relates to erecting a place there, configured as a residence or abode, whether or not that place is or is to be used as a place of residence or abode, including any appurtenances belonging to or enjoyed with the place;

   (c) It is bare land that, under rules in the relevant operative district plan, may be used for erecting a place there, configured as a residence or abode, whether or not that place is or is to be used as a place of residence or abode, including any appurtenances belonging to or enjoyed with the place;

   (d) It is not "excepted residential land", defined in s DH 5(3) as "land to the extent to which it is described in schedule 15".

10. Inland Revenue notes on pages 11-12 of the March 2022 SR that:

    (a) The definition applies to structures that could be used as a residence or abode, and whether they are used as such is not considered by the definition;

(b) DRP does not cover residential properties that are not in New Zealand, therefore, foreign residential properties are not subject to interest limitation under subpart DH.

Excepted residential land

11. Excepted residential land is listed in Schedule 15 as follows:

(a) Clause 1: Business premises, except if the business premises:

(i) Are used or available for use in a business of supplying accommodation; and

(ii) Is not a main home as described in clause 7;

(b) Clause 2: Farmland, including any place configured as a residence or abode, whether or not it is used as a place of residence or abode, including any appurtenances belonging to or enjoyed with the place;

(c) Clause 3: A hospital, convalescent home, nursing home, or hospice;

(d) Clause 4: A boarding establishment;

(e) Clause 5: A hotel, motel, inn, hostel, or camping ground;

(f) Clause 6: A rest home or retirement village;

(g) Clause 7: For the relevant person, land that has been used predominantly for a place configured as a residence or abode, including any appurtenances belonging to or enjoyed with the place, if that place is the main home for 1 or more of the following people:

(i) The person;

(ii) A beneficiary of a trust, if the person is a trustee of the trust and either, it is the main home of a principal settlor, or a principal settlor does not have a main home;

(h) Clause 8: Student accommodation;

(i) Clause 9: For the relevant person, employee accommodation;

(j) Clause 10: Maori excepted land.

12. Inland Revenue notes on page 12-15 of the March 2022 SR that:

(a) Where a single parcel of land contains both a place configured as a residence or abode and a structure that is listed in schedule 15 as being excepted residential land, "standard" apportionment principles apply to exclude the part that is excepted residential land, so that the interest limitation rules only apply to the portion of the land that relates to the residence or abode;

(b) This is usually only relevant where the different structures are on the same legal title, because where they are on separate legal titles, the accompanying loans may be structured separately, making it more straightforward to distinguish between interest that relates to excepted residential land and interest that relates to the DRP;

(c) If the use of a property changes during the year – for example, a person moves into their previously rented home and continues to rent a room to a flatmate, this could lead to a change in status from DRP to excepted residential land (or vice versa), and it will be necessary to determine the status of the property at the time at which interest is incurred to see if interest limitation applies.

13. In relation to "excepted residential land", Inland Revenue's comments on pages 29-47 of the March 2022 SR may be summarised as follows:

(a) The definition of "business premises" in s YA 1 applies for the purposes of clause 1 of schedule 15, and while the interest limitation rules do not apply to property used for commercial purposes, the exception is intended to put any ambiguity beyond doubt:

(i) The exception applies to property that was originally configured as a residence, but has since been reconfigured for use as a non-accommodation business – for example, a villa converted into a doctor's surgery;

(ii) The exception does not apply to premises used for a business of supplying accommodation (unless another of the listed exceptions applies), meaning that short-stay accommodation in a standard residential property is subject to the interest limitation rules;

(b) The definition of "farmland" in s YA 1 applies for the purposes of clause 2 of schedule 15, being land that is being worked in the farming or agricultural business of the land's owner or that, because of its area and nature, is capable of being worked as a farming or agricultural business:

(i) A farming or agricultural business includes forestry, horticultural and pastoral businesses;

(ii) To be "capable of being worked as a farming or agricultural business", the parcel of land must be capable of producing revenue sufficient to cover all costs of holding and operating the land over time without significant investment or modification, and this includes the cost of capital employed and a reasonable recompense for the proprietor's labour;

(iii) Given that the interest limitation rules apply to land to the extent the land contains a place configured as a residence or abode, the exception for farmland in schedule 15 also specifically includes such structures, and any place configured as a residence or abode, whether used as such or not, and including any appurtenances belonging to or enjoyed with the place, is included in the farmland exception, which ensures that a farmhouse or workers' quarters on the farmland is not subject to interest limitation;

(c) Accommodation provided in hospitals, convalescent homes, nursing homes, and hospices is excepted from the interest limitation rules under clause 3 of schedule 15 – Inland Revenue notes that these terms are not defined in the Income Tax Act, therefore, whether a given property qualifies for an exception under clause 3 depends on the particular facts and circumstances;

(d) A "boarding establishment", which is a newly defined term in s YA 1, is excepted under clause 4, to distinguish it from a "boarding house" in the Residential Tenancies Act 1986

("the RTA"), which could simply be a house rented on a room-by-room basis – a "boarding establishment" must be premises meeting all of the following requirements:

(i) It must be located on a single site - Inland Revenue notes that "premises" refers to a single site or location, although the relevant facilities may be in multiple buildings on the same site, and buildings located on different pieces of land do not satisfy the requirements, even if the sections are adjacent;

(ii) The boarding establishment must be used in a business of supplying accommodation;

(iii) It must be managed by the business, which could encompass a manager living on-site, or someone travelling between multiple establishments operated by the business across different locations;

(iv) It must consist of at least ten boarding rooms that are not self-contained (that is, they do not contain all the necessary features for living, such as a full kitchen or bathroom), and

(v) It must include shared living facilities (which provide the necessary features for living not delivered in the residents' boarding rooms) available to all residents;

(vi) Providing the above requirements are met, other boarding or cabin-style rooms on the same site would form part of the "boarding establishment;

(vii) A taxpayer could operate several boarding establishments at different locations, providing each one met all the requirements to be a boarding establishment on its own;

(e) A hotel, motel, inn, hostel or camping ground, are excepted under clause 5 of schedule 15 – Inland Revenue notes that these terms are not defined in the Income Tax Act 2007, therefore, whether a given property qualifies for an exception under clause 5 depends on the facts and circumstances of each property;

(f) A rest home or retirement village is excepted under clause 6 of schedule 15 - Inland Revenue notes that retirement villages and rest homes are subject to regulatory frameworks:

(i) Retirement villages are defined in the Retirement Villages Act 2003 as, broadly, premises containing two or more residential units that provide, or are intended to provide, residential accommodation together with services or facilities, or both, predominantly for persons in their retirement;

(ii) The Health and Disability Services (Safety) Act 2001 considers rest home care to be services provided on premises held out as being principally "a residence for people who are frail because of their age";

(iii) Both retirement villages and rest homes are subject to regulatory frameworks set out in the above;

(g) A main home, as defined in s YA 1 as the one place that is used as a residence by the person or, if they have more than one residence, the residence with which they have the

greatest connection, is excepted under clauses 1 and 7 of schedule 15 – Inland Revenue notes that:

(i) Clause 1 mirrors the business premises exclusion in the bright-line test, which provides that the business premises exclusion applies for premises used for an accommodation business only if it is the person's main home, which is intended to capture, for example, a bed and breakfast establishment where the owner lives onsite;

(ii) Clause 7 permits interest deductions to continue to be taken where a homeowner rents out a room (or rooms) in their main home to flatmates, private boarders, or as short-stay accommodation, and also applies to a non-accommodation income-earning use of the main home – for example, a workshop or a contractor's home office;

(iii) An exception from the interest limitation rules does not mean that interest deductions are automatically available for a main home – expenses relating to private use will not be deductible, and in a flatmate situation, this means apportioning expenses between shared areas, areas exclusively used by the flatmate, and areas exclusively used by the homeowner to determine the amount that is deductible;

(iv) To qualify for the exception, the person who incurs the interest and the person who owns the main home would generally need to be the same person., and in most cases, only natural persons can be considered to have main homes, however, an individual who holds their property through a transparent entity, like a look-through company (LTC), may be able to qualify for the main home exception, because shareholders in LTCs are deemed to hold their proportion of LTC assets directly for tax purposes (opaque structures, such as ordinary (non-LTC) companies, do not have access to the main home exception);

(v) Trusts are generally opaque, but it is not uncommon for people to hold their homes in trust structures, therefore, clauses 1 and 7 contain an additional rule for trusts, which provides that a property can be excepted residential land under the main home exception for the trustee of a trust if it is the main home of one of the trust's beneficiaries and a principal settlor (a person whose settlements for the trust are the greatest, or greatest equal, by market value) does not have a different main home of their own;

(h) "Student accommodation", which is a newly defined term in s YA 1, is excepted under clause 8 of schedule 15:

(i) Being commercial boarding premises used to provide accommodation for students enrolled at a registered school or premises described in section 5B of the RTA; and

(ii) Including premises described in section 5B of the RTA (which refers to student accommodation and describes premises owned or operated by, or in conjunction with, a tertiary education provider) even if they are used mainly, but not exclusively, for the accommodation of students – for example, apartments in a hall of residence that are rented out over the summer break to non-students;

(iii) Inland Revenue notes this applies to halls of residence and hostels that are owned by either the tertiary education provider, or another person who has a specific arrangement with the tertiary education provider, and that meet the requirements under the RTA, but it does not apply to a landlord who leases the residential rental property to students privately;

(i) "Employee accommodation", which is a newly defined term in s YA 1, is excepted under clause 9 of schedule 15 (similar to the exclusion for employee accommodation in the residential loss ring-fencing rules in Subpart EL):

(i) Being property provided by a person, or a company in the same wholly-owned group as the person, to their employees or other workers for accommodation in connection with their employment or service;

(ii) Not including property provided to other associated persons, unless it is necessary for the person to provide the accommodation because of the nature or remoteness of their business;

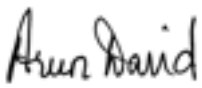
(j) "Maori excepted land", which is a newly defined term in s YA 1, is excepted under clause 10 of schedule 15, being:

(i) Māori customary land, Māori freehold land, Crown land reserved for Māori, and land set aside as a Māori reservation;

(ii) Land provided as a residence to a shareholder or beneficiary of a Māori authority (including an entity eligible to be a Māori authority) to the extent the land is partly or wholly owned (directly or indirectly) by that Māori authority or entity;

(iii) Land owned, directly or indirectly, by a Māori authority (or entity eligible to be one) to the extent the land was acquired under a Treaty settlement or a post-Treaty settlement mechanism (for example, through a right of first refusal) relating to that Māori authority (or eligible entity, but excluding land leased to a third party not owned by a Maori authority or eligible entity – the lessee cannot claim the exception, it applies only to the lessor;

(iv) Partners in a collective housing project that are, or are owned by, Maori authorities or eligible entities.



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