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WEEKLY COMMENT: FRIDAY 20 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 relating to interest deductibility for residential properties and the corresponding changes to the bright-line test. Inland Revenue issued *Special Report on Public Act 2022 No 10* (“the March 2022 SR”) on 31 March 2022 on interest limitation and additional bright-line test rules.
2. In the past two weeks, I reviewed the meaning of disallowed residential property (“DRP”) and “excepted residential land”, and the exemptions for new builds, land businesses, land developments and social, emergency and council housing. This week, I continue reviewing the interest limitation rules and look at grandparented transitional loans and grandparented residential interest, valuation rules for the purposes of subpart DH, simplified interest limitation for a loan drawn down in tranches, and rollover relief for grandparented loans.

Grandparented transitional loan and grandparented residential interest

3. A “grandparented transitional loan” is defined in s DH 5(5) as meaning loan amounts denominated in New Zealand dollars, ignoring re-drawings or additional borrowings under the same loan facility on or after 27 March 2021, to the extent to which the loan amounts are:
 - (a) First drawn down upon before 27 March 2021 for DRP;
 - (b) First drawn down upon on or after 27 March 2021 for acquiring DRP, if the person acquired an estate or interest in the property before 27 March 2021 – for example, if a taxpayer entered into a binding agreement for sale and purchase before 27 March 2021, but settlement and the drawing down of the loan to fund the settlement did not occur until on or after 27 March 2021 (QB 17/02 contains a discussion on when a property is acquired for tax purposes)
 - (c) First drawn down upon on or after 27 March 2021 for acquiring DRP, if the acquisition of the property resulted from an offer that is:
 - (i) Made on or before 23 March 2021; and
 - (ii) Irrevocable before 27 March 2021;
 - (d) In relation to DRP for which a previous owner (the “original owner”) had loan amounts described in paragraphs (a) to (c), if:

- (i) Every transfer of the property since the original owner acquired it meets the requirements in section FB 3A, FC 9, FC 9B(a) to (e), or FO 17 (which relate to roll-over relief for the bright-line rules), treating the relevant requirements as applying to a transfer of the DRP on or after 27 March 2021 (instead of a transfer of residential land on or after 1 April 2022); and
 - (ii) The loan amounts are equal to or less than the amount of the original owner's loan at the time the original owner transferred the property;
- (e) For re-financing, under a new loan facility:
- (i) Loan amounts described in paragraphs (a) to (d);
 - (ii) Loan amounts to which this paragraph (e), or paragraph (f), has previously applied;
- (f) For re-financing, under a new loan facility:
- (i) Loan amounts that would have been described in paragraphs (a) to (d) if it had been denominated in New Zealand dollars – i.e. if a foreign currency loan that would have been a grandparented transitional loan if it had been denominated in New Zealand dollars is refinanced in New Zealand dollars, the refinanced loan is a grandparented transitional loan from the time the refinanced loan is first drawn down;
 - (ii) Loan amounts to which this paragraph (f), or paragraph (e), has previously applied.
4. "Grandparented residential interest" is defined in s DH 7 as meaning interest, for a person and a grandparented transitional loan, that is:
- (a) Interest for the loan's principal to the extent to which the interest is incurred for DRP;
 - (b) If the "underlying loan" is for both DRP and property that is "allowed property", and the portion for DRP cannot reasonably be determined, the portion of interest relating to the "notional loan principal" used to acquire the DRP on 26 March 2021, calculated as:

(Outstanding borrowings) – (Allowed property)
 - (i) "Outstanding borrowings" = [principal of the underlying loan as at 26 March 2021];
 - (ii) "Allowed property" = [26 March 2021 value of assets (excluding DRP) used in deriving assessable income] + [26 March 2021 value of DRP subject to the exemptions in s DH 4];
 - (iii) Applying loan repayments first against the notional loan principal, unless the repayment resulted from a disposal of allowed property, in which case, only the repayments in excess of the value of the disposed of allowed property at 26 March 2021 can be applied against the notional loan principal.
5. Inland Revenue notes on pages 94-101 of the March 2022 SR that:
- (a) Whether the portion incurred for DRP cannot reasonably be determined will be a question of fact and degree in each case - factors relevant to whether the portion of a grandparented transitional loan used for DRP cannot reasonably be determined may include:

- (i) Whether the necessary information is in the possession of the taxpayer;
 - (ii) If the necessary information is not in the possession of the taxpayer, whether the taxpayer can reasonably obtain the information (including from a third party, if necessary – however, the fact the third party charges for the information would not in itself mean that the portion of the loan used for DRP cannot reasonably be determined);
- (b) Allowed property is property not subject to the interest limitation, and a grandparented transitional loan is treated as first used to acquire allowed property:
- (i) If the balance of an untraceable loan is less than the value of allowed property held on 26 March 2021, none of the interest on the loan is subject to interest limitation;
 - (ii) If the balance of the untraceable loan exceeds the value of allowed property held on 26 March 2021, the excess is “notional loan principal” and is treated as having been used to acquire DRP;
 - (iii) Interest on the notional loan principal is treated as grandparented residential interest and is subject to the progressive interest limitation;
- (c) Existing law on tracing applies to changes of use on or after 27 March 2021 – i.e. where the DRP or allowed property held on 26 March 2021 is disposed of and the proceeds are applied to new uses.

Valuation of property for the purposes of Subpart DH

6. Section DH 12 provides that valuation for the purposes of subpart DH of:
- (a) Land, other than land subject to the land business or development, division or building exemption in s DH 4(2) and (3), is at:
 - (i) The most recent capital value or annual value set by a local authority, if acquired before the most recent local authority valuation; or
 - (ii) If acquired after the most recent local authority valuation, at its acquisition cost or, in the case of an associated person acquisition, its market value; and
 - (b) Other property, including land covered by the land business and development exemptions in s DH 4(2) and (3), is at:
 - (i) Its tax book value; or
 - (ii) The financial accounts’ valuation if the person prepares financial accounts according to relevant accounting standards or legislative standards.

Limited denial of deductibility: simplified calculation of interest affected

7. A person can choose to apply the limited denial of deductibility provided for in s DH 10, referred to by Inland Revenue as the “high water mark”. The section is intended to simplify the calculation of interest on a loan that may be drawn down in several tranches.
8. For any given period between 1 October 2021 and 31 March 2025, interest to which the interest limitation rules apply is the amount that can be attributed, for each instant in the period, to the lesser of:

- (a) The initial loan balance, being:
- (i) The loan allocated to DRP for 26 March 2021; or
 - (ii) The drawdown date if it is a grandparented transitional loan drawn down later; or
 - (iii) The drawdown date if it is for an acquisition under the exceptions for residential land transfers in s FC 9B (i.e. the date of the transfer for transfers subject to rollover relief – see paragraph 9 onwards below); and
- (b) The affected loan balance, being the calculated grandparented transitional loan at a particular “balance time”, using the formula:
- (Initial loan balance) + (Advances – Repayments) – (Unrelated advances – Unrelated repayments)
- (i) Advances = Drawdowns up to the balance time;
 - (ii) Repayments = Repayments up to the balance time;
 - (iii) Unrelated advances = The loan portion that is not a grandparented transitional loan in the period from the start to the balance time – i.e. withdrawals from the loan that are applied to something other than a grandparented transitional loan – this could include, for example, another DRP purchased on or after 27 March, a taxable activity including property that qualified as a new build, or private expenditure, or interest charged on the loan that was apportioned to something other than the property funded by the grandparented transitional loan;
 - (iv) Unrelated repayments = Loan repayments applied against the notional loan principal under s DH 7(4) – see paragraph 4 above – this can only arise for a loan that cannot be traced.

Grandparented loans subject to rollover relief

9. If the requirements for rollover relief are satisfied, the recipient effectively steps into the shoes of the transferor (the original owner with the grandparented transitional loan). This ensures that the recipient can deduct a reducing portion of their interest expense incurred during the period 1 October 2021 to 31 March 2025 for the DRP, providing other requirements for tax deductibility are satisfied.
10. The recipient’s maximum grandparented transitional loan cannot exceed the transferor’s loan balance at the time of the disposal – that is, if they borrow more than the transferor owes at the time of transfer, the excess part of the loan is not grandparented, and interest on that excess is not grandparented residential interest and is not deductible.
11. Consistent with the pre-existing bright-line test rules, providing the transferor had a grandparented transitional loan and to the extent the transferee’s loan balance does not exceed the transferor’s loan balance at the time of the transfer, rollover relief is available to treat a loan as a grandparented transitional loan when DRP:
- (a) Is transferred under a settlement of relationship property and s FB 3A applies;
 - (b) Passes from an amalgamating company to the amalgamated company on a resident’s restricted amalgamation and s FO 17 applies; or

- (c) Is transferred, following the death of the owner of the property, to an executor or administrator of the estate or to a beneficiary of the estate and s FC 9 applies.
12. Rollover relief is also provided for some transfers of DRP to or from family trusts. The rollover relief applies to every transfer of the DRP since the original owner acquired it that meets the requirements of s FC 9B(a) or (b) (which link to s CB 6AB(1) and (2) respectively), treating the relevant requirements of that section as applying to a transfer of DRP on after 27 March 2021 (rather than a transfer of residential land on or after 1 April 2022). This is provided that the trust meets the requirements in s CB 6AB(5) to be a “rollover trust” (to be covered in more detail in 2-3 weeks’ time when I look at the new additional bright-line test rules), meaning that:
- (a) Each transferor (in the case of transfers to a trust) or each recipient (in the case of transfers from a trust back to a settlor) of the DRP is also a beneficiary of the trust;
 - (b) At least one of those transferors or recipients of the DRP is also a principal settlor of the trust;
 - (c) Each principal settlor is a beneficiary of the trust and a close family associate (to be covered in more detail in 2-3 weeks’ time when I look at the new additional bright-line test rules); and
 - (d) Each beneficiary is either a close family beneficiary (to be covered in more detail in 2-3 weeks’ time when I look at the new additional bright-line test rules) or trustee of another trust with at least one beneficiary that is a close family associate of a beneficiary of the first trust.
13. For rollover relief to apply when the trustees of a family trust of the type described above transfer the property back to its original settlors:
- (a) All original settlor recipients must receive the same DRP they originally settled on the trust (for example, rollover relief will not apply to DRP transferred to a beneficiary who is not the original settlor of the DRP); or
 - (b) Each recipient’s proportionate interest in the returned property has to be the same as in the original settlement of the property on the trust.
14. Relief is available when DRP is transferred back to the original owner and then settled on a new trust, so rollover relief should also be available for a pure resettlement transaction where the trustees of the trust transfer the DRP to a new trust, provided that a principal settlor of the new trust is also a principal settlor of the first trust and the new trust satisfies all the requirements of s CB 6AB(5) in relation to its beneficiaries. Inland Revenue notes that while this is not currently provided for in the new legislation, it is intended that rollover relief for such resettlement transactions should be introduced in the next available tax bill.
15. Rollover relief also applies when a person transfers DRP to a trust, or receives DRP from a trust in different capacities – for example, if they settled the DRP in a personal capacity and received the property back in their capacity as a shareholder in an LTC. Transfer from an LTC or a partnership to a family trust are also covered in the same way (to be covered in more detail in 2-3 weeks’ time when I look at the new additional bright-line test rules).

16. Relief also applies if a person transfers DRP to themselves in a different capacity, and there is no intervening transfer to a third party. This provides rollover relief for transfers between LTCs and the LTC shareholders or between partnerships and the partners.
17. Inland Revenue notes that the relief is intended to apply to transfers of DRP to or from LTCs and partnerships where each person transferring the DRP to the LTC or partnership (or acquiring it from the LTC or partnership) has the same ownership interest in the property before and after the transfer. It is also intended to apply when DRP is transferred from an LTC to another LTC with identical shareholding (meaning that the two LTCs have the exact same owners who each hold the exact same proportion of shares in the second LTC as they hold in the first LTC).
18. Inland Revenue has noted on page 127 of the March 2022 SR that:
- “Shareholders in LTCs are treated as directly holding the LTCs’ assets, deriving income and incurring expenses in accordance with their shareholding percentage. In effect, LTCs are transparent for tax purposes, which means that the income tax consequences for someone who holds DRP through an LTC are generally the same as for someone who holds DRP directly. Partnerships are also transparent for tax purposes.”
19. Specific relief is also provided for land subject to Te Ture Whenua Māori Act 1993. Rollover relief applies for transfers to a Māori authority (or a person eligible to be a Māori authority) as the trustee of a trust if:
- (a) The DRP is subject to Te Ture Whenua Māori Act 1993;
 - (b) The transferors are all beneficiaries; and
 - (c) The beneficiaries of the trust are all either:
 - (i) Members of the same iwi or hapū; or
 - (ii) Descendants of the same tipuna (living or dead).
20. Similar to the rule for general family trusts, relief is also available when the trustees of a Māori trust of the type described above transfer the DRP back to the settlors of the property, provided those settlors are beneficiaries of the trust. It is intended that for rollover relief to apply when the trustees of a trust of the type described above transfer the property back to its original settlors, each recipient’s proportionate interest in the property has to be the same as in the original settlement.
21. Inland Revenue also notes that, as for ordinary trusts discussed in paragraph 14 above, relief for resettlement transactions is not provided for in the new legislation, but it is intended that rollover relief should be available and should be introduced in the next available tax bill.



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