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14 July 2021

Dear David

KPMG submission on "Design of the interest limitation rule and additional bright-line rules"

General comments on the interest limitation proposal

While we agree with the Government's concerns around housing affordability and objective of creating a well-regulated housing market that can respond to population growth and changes in preference, we are not convinced the interest limitation proposals will help achieve this objective. And certainly, not without significant adverse impacts on the efficiency, coherence and simplicity of the tax system.

We have attempted to analyse the following impacts:

Effect on the housing market

We understand the anticipated effect on the housing market is that house prices will either decrease or not increase as much and that rents will increase. (See Joint Report: Demand-side measures to moderate house price growth Treasury:4405852v1 ("the Joint Report")).

We understand the argument is, in short:

- the after-tax return will decrease as a result of the policy, meaning investors will be prepared to pay less. This is assumed to have a flow on consequence to the whole market, including owner occupiers.
- for the rental market it is assumed that investors will seek to equalise their after-tax returns by increasing rents in the short-term.

We have found no further extended discussion from Officials or Government supporting this analysis. We understand that standard economic approaches would suggest the above propositions generally do not hold.

Further, the residential loss ring-fencing rules were also aimed at reducing house prices. (By a similar logic, deferring net losses reduces cashflow from rental investment so that investors should pay less.) However, there has been no discernible impact on house prices. They have continued to rise which suggests that tax changes are making little difference.

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This is also consistent with the view of the Tax Working Group that the tax system is not an appropriate lever to address housing affordability concerns. It is put, simply, a blunt instrument when the underlying causes are diverse.

(Mis-)alignment with tax policy objectives

We note that at the time of legislating the bright-line extension to 10 years, the accompanying regulatory analysis suggested both Inland Revenue and the Treasury were not in favour of the interest limitation proposals. In fact, the Joint Report, in Annex 3 in particular, provides analysis for why denying interest deductions should not proceed from a tax policy perspective. Apart from the impact on the tax system discussed below in the trade-offs, the proposal would unequally tax some types of rental investment. This would amount to over taxation.

Further, the Joint Report confirms that an owner-occupier is not tax disadvantaged compared to an investor. An owner-occupier is not taxed on the imputed rental income. (From a practical perspective, we note that any attempt to impose such taxation would be unlikely to succeed as imputed rental income is not intuitively income and therefore a proper object of an income tax.)

Is there a tax policy problem?

The current Act allows interest deductions if borrowed money is used to produce assessable income. There is no apportionment of interest if the money borrowed has dual purposes – to produce rental income and to allow continued holding of property which produces a gain which is non-taxable. In turn, the dual holding purpose is insufficiently strong a purpose to make a gain on sale taxable under current rules.

In short, interest which, in part, finances a non-taxable gain is fully deductible.

A possible answer to this problem is the proposed total denial of interest deductions. However, this will over-tax income as no deductions are allowed against rental income (see the Joint Report's own analysis). It is not a first best policy solution as a consequence.

Judging the trade-offs

The discussion document in paragraph 1.5 outlines a number of economic and tax policy objectives which may need to be traded off. These trade-offs are impossible to analyse/evaluate as there is no meaningful analysis provided on the effect on housing affordability or housing supply. The lack of any supporting economic, or other, analysis to suggest that limiting interest deductions would improve housing affordability whilst not limiting new housing supply is a significant concern. Even without that analysis, there are significant doubts that the housing objectives will be met, but in our view the effect of the proposals will be to:

- ***Reduce overall investment efficiency.*** The changes will have effects on the efficient allocation of investment. That must be true as the interest limitation (and bright line extension) changes are designed to make residential rental investment less attractive, from a tax perspective, relative to other asset classes. This will affect the efficient allocation of investment, after-tax, as that is the intention. It is not clear to us what "unintended" effects on investment allocation the Government is concerned about.

- ***Reduce overall tax system coherence.*** The proposal moves the tax system further away from one where different investment activity is broadly taxed in the same way (i.e. a broad-based system) to one where there are multiple "jagged edges", depending on investment type/activity. We recognise that Government may have non-tax policy objectives for certain

tax changes. The interest limitation proposal is simply the latest in the proliferation of ad hoc taxation measures by different Governments. Every ad hoc measure, in our view, further reduces the coherence of the system and risks eroding confidence in the stability and, importantly, predictability of the system.

— ***Significantly increase tax complexity***. The length of the discussion document, at over 140 pages, is instructive in this regard. What sounds simple in a media statement – limit interest deductions on residential property investment, with a carve out for new builds – is anything but due to the various definitional and boundary issues and inter-linkages with other regimes. While the rules will be simple for some, there will be a myriad of ways residential rental properties are owned and finances are organised, which will mean there will be considerably complexity for others. Our detailed comments touch on these issues.

As we have not seen the evidence which justifies the proposal for its effect on non-tax policy, judging the tax policy trade-offs is effectively meaningless. To the extent there is a relevant principle to be derived, it is "do the least harm".

KPMG's principal submission: the Government should not proceed with the interest limitation changes

If there is any analysis of the impact of the interest limitation proposals that supports the non-tax policy objectives, we strongly recommend ***that analysis supporting the proposals is released*** so that submitters are able to make informed submissions.

However, as the proposal has not been shown to produce the non-tax policy objectives and is detrimental to tax policy objectives, we submit that ***the policy should not proceed***.

Despite this conclusion, we understand that the Government has decided to proceed. Our supplementary submissions and detailed analysis proceeds on this basis.

Supplementary submission 1: simplicity should be preferred in the design of the rules

Given the proposals is unlikely to advance any tax policy objective, the "least harm" is likely to be generated by making simplicity the primary objective. Wherever there is a choice to deal with potential behaviour which may be of concern or a perceived need to produce a perfect answer, ***we submit the simplest approach should be preferred. This should be kept in mind when designing the rules***

Supplementary submission 2: the application date should be deferred

To ensure that the rules can be appropriately designed and legislated for and to allow taxpayer education to occur, ***we strongly recommend that the application date be shifted from 1 October 2021 to 1 April 2022 (the start of the 2022-23 tax year) at the earliest.***

Given the truncated consultation process on the detail design and time pressures on legislative drafting, there is a high risk that the interest limitation draft legislation will be sub-optimal when introduced later this year. The 1 October 2021 application date as announced in March will mean that investors will become subject to the rules as the legislative process is still ongoing.

In our view, given the potentially wide impact of these rules and the possibility for change during the process (e.g. at Select Committee stage), it is better for the rules to have application from a prospective date to provide certainty (and the best chance to get the rules right before they apply).

This would have the added benefit of ensuring that only one set of rules needs to be considered for the 2021-22 income year (i.e. full interest deductibility), rather than 100% denial of any interest costs arising on or after 1 October for residential land acquired on or after 27 March 2021 with a 25% denial of the interest cost for residential land acquired prior to this.

As an alternative, the application date could be split so that the rule for acquisitions prior to 27 March 2021 would only apply from 1 April 2022. This would allow investors to properly consider the new rules and apply them prospectively. The new rules would however apply for any acquisitions after announcement date.

Our submission is consistent with Officials views as expressed in the Joint Report.

Detailed submissions

Our submissions on the discussion document are attached.

Further information

Please do not hesitate to contact us, Rachel Piper on 09 363 3525, Darshana Elwela on 09 367 5940 or John Cantin, on 04 816 4518

Yours sincerely

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Chapter 2 – Residential property subject to interest limitation

In defining the type of residential property that should be subject to interest limitation, if the proposal proceeds, we agree that starting point should be whether the property can be used to provide residential accommodation on a long-term basis in New Zealand. Therefore, we support carving out any residential property / land situated outside of New Zealand.

We also support excluding from the scope of the interest limitation rules property that is carved out under paragraph (b) of the “dwelling” definition.

In the “issues for further discussion” feedback is requested on the following:

Change of use from main home during the phase out period for properties acquired before 27 March 2021

We agree the phase out of interest deductions should be available in this scenario.

Dual purpose (business and residential) buildings on the same title

we support an apportionment approach, rather than a predominant use (i.e. “more than 50%” business or residential purpose) test. This should be based on existing apportionment principles (i.e. based on time and space).

Employee accommodation

We agree this should be excluded from scope having regard to the public policy objective underlying this change. Employers providing their employees with accommodation, particularly in critical industries, should be a supported outcome. (There is no tax advantage to the employer or employee as the provision of accommodation, other than in specific circumstances, is taxable).

Student accommodation

We support an exclusion designed around the requirements outlined in sections 5(1)(h) and 5B of the Residential Tenancies Act 1986. The additional requirements imposed under that Act, including the need for accommodation providers to implement, and tenants to abide by, “house rules”, should be sufficient to mitigate risk of substitution.

Short-stay accommodation

Any carve-out for short-stay accommodation should be based on objective criteria, such as features of a dwelling/premises that would make it difficult to substitute for long term residential accommodation. This may include features such as lack of standalone amenities (such as a fully functional kitchen) or private living areas (e.g. if such spaces are largely communal).

Serviced apartments

Similar to short stay accommodation, a carve-out should be based on features that make it difficult to substitute for longer-term accommodation. Where a serviced apartment is otherwise contained in a “commercial dwelling”, such as where the space is predominantly used for hotel operations, this may also warrant the application of the carve-out. While there may be a degree of substitutability, the type of building structure and its overall use, suggests to us that a

serviced apartment in such a setting is unlikely to be a good substitute for long term accommodation.

Māori collectively-owned land

We broadly agree that a carve out for rented papakāinga housing may be appropriate on the basis that papakāinga housing does not compete with owner-occupied housing.

In terms of identifying and defining papakāinga housing, an option may be to limit papakāinga to that on Māori land or Māori freehold land, identified through land records in the Te Kooti Whenua Māori (Māori Land Courts).

Our understanding is that papakāinga housing is often funded by Kainga Whenua Loans. We also understand that it is not uncommon for papakāinga housing to be held in, for instance, company structures alongside other non-residential property assets. As such, in the absence of a full exemption for papakāinga housing there is a potential for tracing to be required. It is possible that papakāinga may be structured in other ways, and further consultation with Te Puna Kokiri and Māori around the structure of papakāinga may be appropriate.

Chapter 3 – Entities affected by interest limitations

Chapter 3 proposes that the interest limitation rule should apply to companies that currently receive an automatic deduction for interest under section DB 7, provided they are either "close companies" or "residential investment property-rich" companies.

Residential investment property-rich company definition

Where a company holds an ownership interest in a residential investment property-rich company, the discussion document proposes that the ownership interest is treated as a "residential investment property" for the purposes of the threshold. We consider that the rules should allow this approach at a taxpayer's option, rather than making it compulsory. Where a taxpayer does not apply this rule, direct tracing for interest would be required.

Valuation considerations

Determining whether a company is residential investment property-rich requires the company to determine the value of its residential investment properties and compare this to the value of its total assets. The discussion document proposes applying the rules in existing section EL 19 to determine the relevant percentage.

While we agree that adopting the existing test in section EL 19 for this purpose is likely to be sensible given that taxpayers and their agents are likely to have some familiarity with the test, we note that any test requiring taxpayers to determine valuations for assets is likely to create compliance difficulties (and additional costs) for taxpayers.

Allowing taxpayers to apply the annual valuations set by local authorities is therefore support to reduce compliance costs. We also support the proposal to allow taxpayers to optionally use accounting or tax book values, rather than market values, for other property.

We note that under section EL 19, assets values are tested at the end of the taxpayer's income year. This creates a risk that a company acquiring land at the end of the income year may technically breach the test even if for most of the year it held no residential property assets. An option that allows taxpayers to test the percentage on an averaged quarterly basis, as is available in the thin capitalisation rules, may be preferable in this regard.

To reduce compliance costs, we submit that taxpayers should be allowed the option of using their accounting book values, as in most cases this should result in lower asset values (as typically, for accounting purposes, depreciation will be at a higher rate than for tax purposes).

Single company test for applying the test

The discussion document proposes that the "residential investment property-rich" test should apply on a company-by-company basis. The exception is for tax consolidated groups, where the test can be applied on a whole of group basis (i.e. treating the group as a "single company").

Requiring taxpayers to form a tax consolidated group in order simply to measure their "residential investment property-rich" percentage as a single company does not seem reasonable. We recommend that any "group of companies" (as defined in section IC 3 of the Act) should have the option of applying the test on a single company basis, by consolidating all companies in the New Zealand group (similar to the test used for thin capitalisation).

Chapter 4 – Interest limitation

Our basic propositions for determining what interest should be subject to the proposed limitation rule is:

- The existing rules are used to calculate the amount of interest, for tax purposes. This means either the financial arrangement or the cash basis persons rules will apply to determine the amount of interest potentially subject to the rules;
- This interest is allocated to private or taxable purposes as currently; and
- Interest incurred for taxable purposes is allocated to:
  - Residential property covered by the new interest limitation rule:
  - Other taxable income purposes (fully tax deductible).

Interest expenditure

We see no need to amend the current rules on how interest expenditure is calculated. This includes non-New Zealand dollar borrowing – the net expense (including foreign exchange gains and losses) should be the object of the rules. We note that interest is deducted first against any foreign exchange gains under this treatment. This is consistent with the current approach of the Act to determining interest expenditure.

Private interest expenditure

For existing loans, private borrowings should already be determined. That allocation should continue to be the basis for applying the transitional phase down rules.

Once the interest limitation rules are enacted, we assume that the private/taxable purpose allocation will be done when money is borrowed. Private interest expenditure would continue to remain non-deductible.

Tracing for companies

For companies, as there should be no private borrowing there would be no requirement to trace. For existing borrowings, the rules that apply to establish the purpose to be used in the transitional phase down will determine how the borrowing is allocated.

New borrowing/acquisitions

We assume the allocation to residential property would be determined at the time of borrowing. Interest allocated to residential property would be non-deductible in the current year. This interest should be carried forward and potentially offset/deducted in the year of sale (if the sale is taxable) per our submissions on Chapter 5.

This means:

- If no residential property is acquired, there would be no non-deductible interest. That would appear to be the case whether or not residential property is subsequently acquired (as the money has already been borrowed for another purposes).
- If residential property is acquired, borrowing will need to be traced to that use and interest deductions will be denied accordingly.

Specific allocation rules proposed

Refinancing

We agree that refinancing of loans used to acquire property, subject to the phase out of interest deductibility, should still qualify for the transitional phase down rule.

However, we disagree with the proposed treatment for a loan refinanced in another currency. This is inconsistent with the Act's scheme to treat all loans as if they were NZD loans on an accrual basis. (This is the effect of the current rules dealing with foreign exchange gains and losses.) The answer is a simple application of current policy leaving commercial decisions on how best to borrow to taxpayers.

Non traced loans

We consider that option 1 (apportionment) is logical if the original borrowing is likely to be for the original cost of the relevant assets. However, this is less likely to be the case for revolving credit facilities and ignores the ability to restructure borrowings.

We therefore prefer option 2 (stacking), for simplicity. We note that there are likely to be winners and loser from this approach as it will depend on how market values have changed (compared to the original cost and amounts borrowed). However, as any restructuring of borrowings would also be market value based, option 2 provides an equivalent result.

From a pure policy perspective, option 1 is likely to raise the question of whether a specific anti-avoidance rule is required to prevent restructuring or whether section BG 1 may apply to restructuring. We consider that option 2 does not raise those questions.

Example 12 – revolving credit facility

Example 12 (on page 49) assumes that the loan amount subject to the transitional phase down rule should not be increased for any reason. This leads to the high water mark proposal.

We have difficulty seeing any policy problem illustrated in the example which requires a solution of this type.

In the example, the increases are due only to the timing of the receipt of rent and the payment of interest. On an end of the day basis, there is no increase in the amount borrowed. There should be no need to adjust the qualifying deductible borrowing.

We understand that some facilities could allow for additional borrowing. We submit that the approach should be:

- Additional borrowing for the purposes of the existing residential property activity should be deductible but subject to the transitional phase down rule.
- Additional borrowing for new residential property will be subject to the proposed rules (i.e. deducible for a new build and non-deductible for existing residential property).
- Additional borrowing for private or other taxable use, would be deductible or not based on the use of the funds.

This would allow a simple calculation of net borrowings for each purpose to be done annually to determine the proportion of interest subject to each rule.

This approach has simplicity as an advantage. It is justified on the basis that it is reasonably foreseeable that a taxpayer will incur further expenditure as a result of having acquired residential property. The interest is therefore properly attributed to the pre-change use.

Offset arrangements

We note the effect of an offset arrangement is that interest expenditure is "deducted" against interest income first (as the offset reduces interest paid to the taxpayer.) Accordingly, offset arrangements should only be within the rules if there is net interest expenditure.

Our suggested approach to revolving credit facilities could be applied to determine how much, if any, of this interest is subject to the residential property rules.

Foreign currency denominated loans and hedges

As above, we disagree with the proposed approach to foreign currency denominated loans and therefore foreign exchange hedges. In principle, there is no difference between New Zealand dollar denominated loans and foreign currency denominated loans. This is the approach taken by the Act which assumes an economic equivalence between the net result of a foreign currency denominated loan and New Zealand dollar borrowings.

On this approach, interest expenditure would be calculated as currently on a foreign currency loan and subject to the proposed rules accordingly.

If there are any foreign exchange hedge instruments, the result of the tax calculations for the foreign currency loan should be included in the net interest calculation for the loan.

Chapter 5 – Disposal of property subject to interest limitation

Options for treatment of revenue account disposals

We do not favour Option A (deductions denied). Under Option A, investors could potentially face a tax liability where they have actually made an economic loss on disposal of residential property, or a tax liability that significantly exceeds that on other investments with an equivalent economic return. The clear fairness and coherence concerns with Option A are not outweighed by any housing affordability objectives.

We prefer Option B, as its effect is that interest deductions should be available where returns from holding the property are appropriately taxed. We do not favour Options C or D, which add additional complexity in order to address a perceived arbitrage risk (discussed further below) and will over-tax residential property as a result.

Options for treatment of capital account disposals

We favour Option F, which allows a deduction only to the extent that the interest expenditure exceeds the non-taxed gain on sale of the property.

In our view, Option F effectively recognises that the interest cost incurred relates to both the capital gain amount and the taxable income that has already been returned during the period of ownership.

Arbitrage considerations

From a tax policy perspective, we do not see any reason why anti-arbitrage rules are required.

To the extent that a policy decision has been made to tax residential land, all "economic income" (whether from holding for rents or capital gains) will be taxed and allowing deductions is consistent with taxing only the net economic return to an investor.

Setting aside the tax policy considerations, from a social policy view, we also do not see any justification for the suggested anti-arbitrage approach. To the extent a tax loss might arise due to allowing a deduction for capitalised interest on disposal, at the margin, this may encourage investor to sell rather than hold on to the property. To the extent this increases available supply, this could be expected to benefit owner-occupiers.

Chapter 6 – Development and related activities

KPMG supports the proposed exemption for development activity. Land developers are adding to the housing stock and should be entitled to a full interest deduction.

We also agree that the exemption should apply on a property by property basis rather than on a taxpayer basis.

KPMG does not agree with the comment at para 6.11 that almost everyone who develops residential property will hold the property on revenue account under section CB 7. Many taxpayers developing residential property will not be caught by section CB 7.

We therefore agree with the proposal that the developer exemption needs to be wider than just covering CB 7 to also capture one-off developments by people who are not in the business of developing land and also property development on land that is not captured by section CB 7.

Where land is not acquired for the purpose of development, but that intention is formed later, interest should be deductible from the time the intention to undertake a development is formed. The interest should be deductible on both the additional debt used to fund the development acquisitive and also on the debt used to acquire the property (for the time the intention to develop the property is formed).

We support an exemption to allow interest on debt funding for remediation work where the work is necessary to extend the life of a residential property, bring it to a more suitable standard for habitation (for example, remediation specifically to meet the 'healthy homes' standard to uplift the quality of New Zealand rental stock), or to convert a building from non-residential to residential use. We believe this is consistent with the wider policy objectives of the new build exemption.

Chapter 7 – Definition of "new build"

We agree that an exemption should be made for new builds in order to ensure new housing supply is not constrained, if the interest limitation proposal proceeds.

We agree with the proposed definition of new build.

We agree that, in principle, renovating an uninhabitable dwelling so that it becomes habitable should qualify for the new build exemption on the basis that this increases the total housing supply. Again, having regard to the Government's wider housing objectives, it seems counter-intuitive that these types of conversions should be excluded from the new build exemption. This would create an incentive to demolish rather than remediate, at the margin, for tax purposes

While we acknowledge the potential complexity from differentiating between renovating an uninhabitable dwelling and other renovations, we do not believe this would be insurmountable. And to our general comment, if the trade-off is between accuracy and simplicity/supporting the wider objectives, we would err on the latter.

Chapter 8 – New build exemption from interest limitation

Fixed new build exemption period supported

If the interest limitation proposal proceeds, we support the proposed new build exemption being available to both early owners of a new build, and to any subsequent purchasers of properties that qualify as a new build.

It is important that, for an initial owner looking to invest in new housing supply, there is a secondary market available on the eventual sale of properties and the tax system does not create uncertainty around valuation on sale.

Interest deductibility will be one of the variables that is taken into consideration when determining the pricing, and ultimately the feasibility, of a new build project. It is therefore important that investors have certainty over the period that they, and/or any future owners, will be entitled to claim an interest deduction at the time they make the investment decision.

We therefore support allowing interest deductibility for a fixed period for both early owners and subsequent purchasers.

It is important that the period of the new build exemption does not discourage the development of new housing stock. We suggest that the new build exemption should apply for a maximum period of 30 years. This includes for early owners who hold the property for more than 30 years (i.e. interest deductibility would cease after year 30 for them). We note that there is no exact science to picking the exemption period. One argument is to align the period with the Commissioner's estimated useful life for buildings – 50 years. However, an argument could be made that this is too generous. A 30 year period reflects, in our view, an appropriate balance between the need for certainty (which a fixed exemption period would provide) and a realistic total period for debt funding a new build (including where there may be multiple owners).

Continued investment rule not supported

We do not support the proposed continued investment rule, where a residential property that is subject to the new build exemption may be owner occupied.

It is simply not practical to require subsequent purchasers to undertake due diligence regarding use of the property by all earlier owners in order to confirm their eligibility to claim interest deductions (through continued application of the new build exemption). Further, the period being considered for the new build exemption will exceed the general record keeping period of 7 years. So, unless information on the applicability of the new build exemption is collected by Inland Revenue periodically (e.g. as part of the tax return), and is available to subsequent owners on acquisition, this will be a difficult rule to both comply with and enforce.

There will also be circumstances where an initial owner may need to temporarily move into a new build for a period of time before renting it out (for instance, if a person develops two properties at once, one to live in and the other to rent, and lives in the latter while the former is being completed) where the initial owner should not be precluded from applying the new build exemption.

Ultimately, we do not believe that the value of the continued investment rule in potentially creating more stock for first-home owners is justified for the additional complexity of the rule.

Chapter 9 – Five year bright-line test for new builds

We support retention of a five year bright-line period for new builds.

We recognise the rationale for wanting to limit the benefit of the shorter bright-line to early owners only. However, consideration should be given to whether its application to subsequent purchasers as well may better support the Government's objective of encouraging new housing supply.

Chapter 10 Rollover relief

We support the availability of rollover relief for both interest deductibility (during the interest phase out period and under the new build exemption) and for a wider range of scenarios under the bright-line test.

Rollover relief under the new build exemption should apply regardless of the new build exemption option chosen.

From a policy perspective, rollover relief should not only be available if new build exemption is limited to early owners in perpetuity. If the new build exemption is time capped (i.e. applies for a total fixed period across both early owners and subsequent purchasers), rollover relief should still be available for designated events.

Scope of bright-line rollover relief for family arrangements.

Paragraphs 10.7 and 10.8 outline an increasingly common occurrence where parental support may be necessary for first home buyers to enter the housing market. The discussion document notes that such arrangements can give rise to adverse tax consequences under the bright-line test. We agree and note that these issues will be exacerbated with the extension of the bright-line period to 10 years. In particular, we are concerned that the bright-line test could apply if a person other than the principal borrower(s) must also be listed on the title for a residential property in order secure bank funding (i.e. effectively acting as the guarantor). We submit that these types of situations should be addressed as a matter of priority, rather than "work being undertaken at a later date".

Application of full bright-line test rollover relief for settlements on a family trust.

We strongly support the extension of the bright-line test rollover relief to situations where residential land acquired prior to the bright-line test (or that was subject to the 2 or 5 year versions but following their expiry) is transferred to a trust.

However, the parameters for availability of such relief are not clear (for example, paragraph 10.31 suggests that rollover relief may be allowed where "a settlor settles land onto a trust in return for the trust providing the settlor the right to occupy the property free of charge (i.e. for natural love and affection)".

We believe this should also be the case where pre-bright-line test residential property is gifted to a trust or the property is sold to a trust in exchange for a loan. In both cases, if the transferor is also the settlor and a beneficiary of the trust, there is no change in economic ownership of the property, so there is no reason why the bright-line test should apply when it did not originally (or the bright-line period has otherwise lapsed).

Chapter 11 – Interposed entities

These proposals contain the most difficult rules to apply in practice. The require serious simplification to allow them to be used.

Affected assets percentage and apportionment calculations – closely held and other interposed entities

Paragraphs 11.6 to 11.9 do not specify when the calculation is performed. However, paragraph 11.14 and subsequent imply that this could be a year end test or a daily test (or something in between). 11.16 states that a "daily calculation" does not require a calculation everyday but that a calculation must be done for every day.

A good dose of common sense is required.

The PIE rules require daily calculations and attributions of income and expenditure for each PIE. These calculations are carried out by systems developed and operated by sophisticated fund managers and administrators.

A full attribution regime for company income has not been implemented in larger part due to the difficulty of doing daily calculations and attributions.

In both cases, the calculations are those of the entity itself. For the interposed entity rule, the shareholder would be required to access information from the entity and calculate their own apportionment. The entity would have to be able to provide that information on a daily basis.

This is an onerous burden. We can only conclude, in the words of a former Minister of Revenue and Finance, that this is an "ideological burp" and not to be taken as a serious proposal.

Most companies will only prepare annual financial statements. That should be the starting point for what is possible and realistic for them to provide to shareholders.

This means that an avoidance rule should be considered. An appropriate rule could eb modified from the thin capitalization rules. We are not aware of any specific difficulties with applying these rules or that have not achieved their objective. On the latter, any uncertainty of application is likely to mean that changes in the ratios are most likely the result of commercial decisions. Further, any "asset stuffing" to increase the non-residential property proportion would need to be funded. Existing funds would not change the proportion (i.e. from cash to some other asset). Other increases would require either debt or equity funding. The terms of such funding would likely make it easier to determine whether the anti-avoidance rule should apply.

Trusts

We have referred to companies as an inter-posed entity as it is difficult to see how borrowing to fund an inter-posed trust would be effective. A taxpayer borrowing to provide equity to a trust would not normally be considered to be borrowing to produce assessable income. A trust is therefore most likely to be involved in the on-lending scenario covered at paragraphs 11.28 to 11.30 and considered below.

Widely held companies

If implementing the proposals will be difficult for close companies, it will be even more difficult for shareholders of widely held companies. Information is unlikely to be able to be provided on a

timely basis. If the company is listed there will be insider trading and NZX rules which may limit the type and timing of information provided to shareholders.

The current interest deductibility rules provide some certainty of deductibility. For investments in widely held companies, the interest deduction and therefore the taxable income, may be volatile.

We consider that a widely held company rule may not be required. It is unlikely that borrowing to invest in affected companies will be done to allow deducible interest.

However, if the rule proceeds, then the apportionment should be based on the company's prior year balance sheet. This is likely to assist investors with estimating their current year tax and also would reduce delays in the provision of information required for an income tax return.

For example, the company would provide shareholders with its 31 March 2022 percentages to be applied to the calculation of 31 March 2023 tax position.

If this approach was taken, then an apportionment should be allowed.

Look though companies and partnerships

A clarifying provision to ensure that the debt is apportioned to the assets of the LTC or partnership seems reasonable. However:

Depending on how this is drafted, it may raise questions on the taxation of an LTC or partnership more generally. Those consequences should be considered and dealt with.

The shareholder or partners access to relevant information should be considered. As this rule would mean that loans are traced to assets consideration needs to be given to how the primary rules can be given effect for a taxpayer who is not the entity with the entity's access to information.

Existing interposed entities

Given that nothing in the proposed rules is simple, we disagree with the proposal for existing loans. If due to compliance costs a taxpayer chooses not to apply apportionment and tracing rules, that should be the taxpayer's choice. Other taxpayers should have the same ability as direct acquirers of residential property.

Disposal of interest in inter-posed entity

Our submission on existing interposed entity treatment suggests that denied interest should be allowed as a deduction if either the property asset or the sale of the shares in the interposed entity is taxable.

On-lending

We agree that in the example it is only an anti-avoidance rule which needs to be considered. We note that less than market interest on-lending would raise the possibility that BG 1 would apply. (However, we note the restricted transfer pricing rule is premised on related party borrowing making no or very little margin. This is contrary to the market value assumption that is implied as required by BG 1.)

We have considered an alternative example. Zeean lends to her Family Trust, at interest, which acquires shares in LandCo. The Family Trust would be subject to the interposed entity rule and

its interest would be apportioned in accordance with those rules. The anti-avoidance considerations would still apply to the interest rate charged by Zeean to the Family Trust.

Chapter 12 – Implications for the loss ring-fencing rules

As an initial observation, on the basis that the Government proceeds with the interest limitation rule as proposed, it would seem that rental investment properties are very likely to produce taxable profits, with losses being expected only at the margins. This is particularly so given that depreciation deductions are no longer available for residential investment properties. On that basis, our preferred approach is that the existing rental loss ring-fencing rules are repealed.

We further observe that if the rental loss ring-fencing rules are not repealed, we would expect the interface between the proposed interest limitation and the existing rental loss ring-fencing rules to become exceedingly complex. This is likely to result in potential unintended consequences.

To the extent the Government is not prepared to repeal the existing residential loss ring-fencing rules, we support carve outs for new builds and development properties on the basis that doing so will encourage new supply to the market, with the objective of lowering prices for potential owner-occupiers.

For reasons given above we do not consider that anti-arbitrage rules should be required, and we would not favour such rules in any case as they will likely result in considerable complexity.

Chapter 14 - Administration

Chapter 14 considers the administrative aspects arising from the Government's proposal to limit interest deductions and extend the bright-line tests for residential investment properties. We comment specifically on the questions raised by officials below.

Adding a field to tax return

We do not consider that any particular issues should arise from adding a new field to the tax return to capture the amount of interest relating to residential investment property debt. To the extent that taxpayers have had to trace their borrowings to residential property and determine the interest subject to the proposed deduction denial, itemising that amount in their tax return should not be an onerous task.

Record keeping

In light of the proposed extension of the bright-line test to 10 years, Inland Revenue should provide further detail as to its expectations around record keeping. Under the current settings, taxpayers are expected to keep records for a period of seven years from the end of the year to which the records relate.
Because the proposed 10-year bright-line test could 'bite' between year seven and year 10 without the taxpayer anticipating a tax liability, there is a risk that taxpayers may have discarded records at year seven making it difficult or impossible to quantify any tax liability.
In a practical sense, the new bright-line test may now imply that records must be held for 10 years.

Code Compliance Certificates

The Discussion Document suggests that Code Compliance Certificates ("CCC") might be used to evidence that a property is a new build under the proposed test. We consider that this is likely to be a reasonable approach given that all new builds will have a CCC issued once they are constructed to a standard suitable for occupation. We are not aware of any integrity risks that could arise from this approach.

Subsequent purchasers

To the extent that subsequent purchasers are able to take advantage of the new build exemption, there is a potential commercial risk as to the information that the subsequent purchaser will need to establish that the exemption applies. Depending on the design of the subsequent purchaser rule, and whether the rule requires any form of disclosure by the vendor so that the purchaser can determine its tax obligations, there could be a potential contractual risk between vendor and purchaser (similar to the kinds of risks under the GST CZR rules). There may be value in consulting with ADLS as to whether any of the standard terms in the ADLS SPA require amendment, or whether a specific disclosure schedule is necessary.