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Ring-fencing rental losses
C/- Deputy Commissioner, Policy and Strategy
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Dear Cath

KPMG submission on ring-fencing rental losses

KPMG is pleased to make a submission on the Officials' Issues Paper on ring-fencing of rental losses (the "Issues Paper").

Policy concerns – implementation should be deferred

The Issues Paper notes that investment housing is currently taxed under the same rules that generally apply to other investors. We agree with this statement.

However, it then goes on to make assertions for which no support is provided. For example, it states that "*the fact rental property investors often make persistent tax losses indicates that expected capital gains are an important motivation for many investors purchasing rental property*". This is then used as the justification for rental loss ring-fencing: …"*to the extent deductible expenses in the long-term exceed income from rents, those expenses in fact relate to the capital gains, should not be deductible unless the capital gain is taxed*".

We consider this to be an unprincipled argument, not least because the proposal is not aimed only at those making persistent tax losses on their rental investments. One-off rental losses will also be quarantined. Depending on a person's individual circumstances, this could have material implications (including losses never being able to be used).

Moreover, it calls into question the general tax policy framework for taxing investments, given the first statement above. We see no difference between a rental property where the interest costs exceed the rental stream and an investment in NZ shares, also on capital account, where the interest costs exceed the (taxable) dividend stream. Why is the proposal to ring fence the loss in relation to the former good tax policy but not the latter?

We are also concerned with the (mis)use of the term "speculator" in the description of the targeting of this rule. A "speculator" to us (and we would expect for most people) is someone who acquires an asset with the intention of realising it for a gain. Such persons are already taxed on their gains (and losses) under the existing rules – i.e. they do not make "capital gains". Therefore, the stated policy justification for denial of expenses expressed above does not apply to them.

The above highlights the difficulty of applying a tax policy framework to support the rental loss ring-fencing proposal. It is simply not good tax policy, in our view.

The policy driver, while not stated in the Issues Paper, appears to be to improve New Zealand housing affordability.

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We note the Tax Working Group has been asked by Government to look specifically at the issue of whether current tax system settings are impacting on housing affordability. We believe that should be the forum for looking comprehensively at this issue.

We therefore recommend that consideration of the rental loss ring-fencing proposal should be deferred until the Tax Working Group has reported to Government with its final recommendations. This would allow Government the opportunity to consider whether the rental loss ring-fencing proposal is actually required, as the Tax Working Group's recommendations may better address the underlying issues the current proposal is aimed at.

The rules will potentially impact a large number of taxpayers and their existing arrangements, including where different investments, not just rental properties, are held through entities. (We note special rules are proposed which will deny personal interest deductions to the entity's owners and comment on this in our detailed submission points.)

There is unlikely to be sufficient time, between the introduction of draft legislation later this year and its enactment, given the proposed 1 April 2019 application date, for taxpayers to fully assess the impact of the change on their circumstances and to make adjustments, if required.

This too supports deferral of introduction of the rental loss ring-fencing proposal until after the Tax Working Group's final report next year.

Alternative approach

The proposal will result in a rental loss, regardless of the underlying cause, being quarantined. This will include situations where a loss is due to "hard costs", such as significant repairs and maintenance, during a year. We understand the policy concern is not necessarily with rental tax losses due to those costs, but where there is ability to "artificially" inflate losses through negative gearing of properties (i.e. maximising the tax benefit of interest costs).

If that is the real concern, a more targeted approach is an ordering rule which limits interest deductions to gross rental income. Other ("hard") expenses could still be deducted, and to the extent that results in a loss, that loss would (and should) still be allowed. However, any excess interest deductions would need to be carried forward for future offset.

While not our first preference, as it would still be an arbitrary measure, it would at least better target (what we understand to be) the concern as compared to a general rental loss ring-fencing rule.

If the proposal proceeds…

If the rental loss ring-fencing proposal proceeds, we set out below the key design issues that will need to be considered further.

Property the rules will apply to

We are concerned that proposal could apply to residential land where gains are taxable.

We have noted above the unhelpful references in the Issues Paper to the rule applying to "speculators". We would class speculators as those who acquire residential land with the intention of disposal and should, therefore, be subject to the test in section CB 6 of the Income Tax Act 2007.

Gains on sale of residential land that are taxable under section CB 6 are not part of the proposed exclusions from the rental-loss ring-fencing rule (based on our reading of the "revenue account" land exclusions). That seems unfair, given the stated policy rationale for denying deductions is that capital gains are not taxed.

Similarly, it is unclear why those subject to the "bright-line" test in section CB 6A are also not excluded from these rules, particularly with the extension of the bright-line period to 5 years.

We presume the argument is that the application of the section CB 6 and 6A tests is less clear than the "business" of land dealing, development, subdivision and erecting building tests. However, we note that those latter tests also taint associated parties not carrying on the relevant business and capture certain land, but only if disposed of within 10 years of acquisition.

On the basis the revenue account land exclusion from the loss ring-fencing rules where the taxpayer is in the business of dealing, developing, subdividing or erecting buildings on land will apply without exception, its non-application to section CB 6 and 6A is unprincipled.

We therefore recommend that taxpayers should also not be subject to the proposed rental-loss ring fencing rule in relation to a residential rental property that is held on revenue account due to the application of section CB 6 and 6A.

Further, by claiming a rental loss in relation to the property in their tax return, the taxpayer (if not in the business of dealing, developing, subdividing or erecting buildings on land) would be asserting that section CB 6 applies to that property. This could then be more easily enforced by Inland Revenue if a different tax position is taken (i.e. no gain on sale is returned on disposal, for tax purposes).

Single versus multiple property landlords

The Issues Paper does not distinguish between taxpayers who hold one residential rental property and those holding multiple properties.

While we understand the rationale for not distinguishing between situations depending on the number of residential investment properties owned, the policy is arguably inconsistent with the Government's 2017 election policy which stated:

> *Speculators will no longer be able to use tax losses on their rental properties to offset their tax on other income, a practice called negative gearing. This move has been recommended by the IMF and the Reserve Bank.*
>
> *The biggest users of this loophole are large-scale speculators who own multiple rentals and use losses on new acquisitions to continually reduce their tax. The speculators' tax loophole helps them outbid home buyers for properties because the taxpayer effectively subsidises part of their cost of servicing mortgages.*
>
> ***Ending this loophole will not affect most people who have bought a single rental as a long-term investment, because most of them are not using it. Those that do use this loophole generally only do so for a few years after purchase.***

It is not clear that there is a deliberate departure from this policy. That should be confirmed. (We note again our observation that the use of the term "speculator" is unhelpful to the development of good tax policy.)

Application of the "main home" exclusion

The Issues Paper proposes that residential property that comprises a taxpayer's "main home" will not be the subject of the rental loss ring-fencing rule. The Issues Paper notes that this is intended to exclude boarders and the rental of spare rooms being subject to the restrictions. It should be clarified that the intended application of the main home exclusion is wider than this – e.g. should also apply if a person's family home is rented out while they are temporarily away or where "losses" are due to deductible home office-type expenses.

We note that the main home test can be difficult to apply in practice. For example, where a taxpayer has rented out their New Zealand property while working overseas. In that situation,

their single main home, per the tests outlined in paragraph 3.8, would arguably be in the country they are working in (e.g. if their family, employment and person property is in that other country). This would mean any New Zealand rental losses will be ring-fenced. This is notwithstanding the property would be their main home if they were living in New Zealand (and, for tax residence purposes, it could still be considered as giving rise to a permanent place of abode by Inland Revenue).

To address this concern, the "main home" exemption should be available for a person's residential New Zealand property (if that was, or could reasonably be, their main home if living here) where they continue to retain their New Zealand tax residence.

Another concern is that those who buy a rental property to get on the NZ property ladder (which is not uncommon in today's heated property market), but end up using the property as their family (main) home over time, may have rental tax losses which are not able to be utilised. It is not clear how the main home test is intended to apply in such a case.

We consider that any tax losses generated when the property was used as a rental property should become unrestricted if the property subsequently becomes the owner's main home.

Non-New Zealand residential properties

Based on our understanding of the policy driver – to help with local housing affordability – there is no policy justification for applying the loss ring-fencing proposal to non-New Zealand residential properties. These should be excluded from the scope of the proposal.

This is particularly as the issue highlighted above for the main home exemption will also apply where someone is seconded to work in New Zealand and they rent out their overseas family home while living here. If they become New Zealand tax resident, they will be taxable on their net foreign rental income. Assuming their mortgage is denominated in a foreign currency, New Zealand's financial arrangement rules can give rise to significant unrealised income/(losses) for tax, due to currency fluctuations. Therefore, the New Zealand tax result may have little relation to the actual rental position – the loss could relate solely or largely to unrealised foreign currency movements on the mortgage.

If a general exclusion for non-New Zealand residential properties is not supported, at a minimum, an exclusion should be available for the non-New Zealand residence of a "transitional resident" (if that would or could be their main home if living overseas).

Property owned by companies and trusts

The proposal is to apply the loss ring-fencing rules to companies and trusts that hold residential rental properties. While on the one hand we can appreciate the rationale for not wanting to exclude companies or trusts (and presumably partnerships?) from the proposal, this will impose significant compliance costs. The acknowledgement in paragraph 3.20 that there may be "some" compliance costs is not sufficient in that regard.

Affected companies or trusts would need to separately identify deductible expenses, including interest costs, relating to any residential property investment. This will be easier said than done if the entity holds other investments, or undertakes, other taxable activities. For example, it is not clear why a retirement village which has both rental villas and a rest home which are part of the total business of the retirement village should be required to apportion its costs between the two activities to determine whether the loss ring fencing rules apply or not. It is not acceptable for these businesses to be collateral damage in the application of this rule.

Therefore, to ensure that these rules do not impose disproportionate and unwarranted compliance costs, we recommend that:

— Their application be limited to look through companies and partnerships (and companies subject to the personal services attribution rules), being the type of entities where rental losses could genuinely be used to offset their "owners'" labour income; and

— Rental loss ring-fencing should only apply if the LTC/personal services attribution company or partnership meets the "residential property land-rich" definition proposed under 6.11.

Portfolio basis

The Issues Paper notes that a portfolio approach is preferred, allowing taxpayers to consider the taxation of their rental properties as a pool rather than on a property-by-property basis. We support this portfolio approach, if the proposal proceeds as outlined.

Using ring-fenced losses

It is not clear how the proposed carry forward mechanism would apply if the loss is generated in a company. As the rental loss ring-fencing proposal would apply independently of the other net taxable income of the company, there could be quarantined rental losses when the overall position for the company is tax paying. Therefore, we recommend that if the proposal as outlined in the Issues Paper proceeds:

— That the 49% minimum commonality of shareholding requirement for carrying forward general tax losses not apply to ring-fenced rental losses.

— If our submission above is not supported, in the year in which minimum 49% shareholder continuity is breached, any ring-fenced rental losses should become fully available to offset other (non-rental and land gains) income.

Interposed entities

The rules being proposed to counter structuring at the investor/owner level illustrate the complexity created by rental loss ring-fencing in general.

The suggested preference is for an interest denial rule for owners of entities that are "residential property land-rich" (i.e. if residential rental properties comprise more than 50% of the value of total assets), to the extent the interest exceeds taxable distributions from the entity (this appears to be a proxy for the entity's "rental property income"), and the owner's other rental income or taxable land gains.

This raises a number of practical concerns and questions:

1. The Issues Paper notes that interest allocation rules were considered but are not supported as they would add considerable complexity and compliance costs. However, the proposal, operationally, appears to us to be the same as an interest allocation rule. This is because it will still require taxpayers to distinguish between funding to acquire interests in entities that are residential property land-rich from other entities (e.g. that hold predominantly financial investments, such as shares and debt) or financial investments directly. Otherwise, funding costs relating to those other entities/financial investments would also be ring fenced as all of the owner's interest deductions would be allocated first to their investment in the residential property land-rich entity. That would disproportionately disallow interest deductions and there would be no opportunity for taxpayers to re-structure their affairs to avoid application of these rules for other investments. That is not what we understand the policy intent to be.

2. The Issues Paper notes a similar concern in relation to trusts but does not discuss this in detail. Therefore, it is not clear how widely the interest restriction will apply. For example, it will be the settlor of the trust that will have interest deductions, if any (although it is not

clear to us how they would have deductible interest if they simply settle the property on the trust). But, it will be the beneficiaries that are subject to the "rental property income" test as they would receive the taxable distributions. The settlor(s) and beneficiaries will not always be the same persons. It is not clear how or why the proposed rule is required for a trust.

3. The owner's interest limitation rule would apply in addition to the proposed ring fencing at the entity level. This could result in a double denial of interest deductions (e.g. once at the entity level and again at the owner's level, if there is a "back to back" loan arrangement between the entity, its owner(s) and the bank.) Any income from any such funding arrangements should be included in the owner's calculation of any loss ring fencing.

Timing of introduction

The Government's 2017 election policy suggested that any changes would be phased in over a five year period (with 20% of the loss ring-fenced in the first year; 40% in the second; and so on). The Issues Paper asks for submissions on whether a phased introduction over 2 or 3 years should be considered.

If the rental loss ring-fencing proposal proceeds, we strongly support a phased introduction to allow affected investors time to adjust to the new rules, or to rearrange their affairs before the rules apply in full. The phasing of the new rules should be over 5 years per the original election policy. This will also allow time for the inevitable corrections to be made while those errors would have a lower impact.

The Issues Paper is silent on the treatment of any pre-existing (i.e. 2018-19 income year or earlier) rental losses "carried forward", as a general loss balance. We assume that these losses will be able to be utilised as normal.

Further information

Please do not hesitate to contact us, Rebecca Armour on (09) 367 5926 or Darshana Elwela on (09) 367 5940, should you wish to discuss our submission.

Yours sincerely

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