

Property Council New Zealand

Submission on the Government discussion document on the design of the interest limitation rule and additional bright-line rules

9 July 2021

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Government's discussion document on the design of the interest limitation rule and additional bright-line rules

1. Recommendation summary

- 1.1 Property Council New Zealand (Property Council) does not support the proposed changes to the interest deductibility rules as set out in the Government's consultation document regarding the design of interest limitation rule and additional bright-line rules. Our position is that the Government should not progress these changes and should instead consider other mechanisms by which to reduce demand and increase supply in the housing market.
- 1.2 In the alternative, if the Government does choose to progress these changes, Property Council makes the following recommendations:
- The Government specifically exempt Build-to-Rent developments, and create an asset class that considers Build-to-Rent as a commercial asset rather than residential;
 - Progress other changes of barriers to unleashing Build-to-Rent;
 - Adopt the apportionment approach to ascertain purpose for dual purpose properties;
 - Legislate a carve out for purpose-built student accommodation and for serviced apartments;
 - Initial owners of new builds be given an exemption in perpetuity, and subsequent owners of new builds be given either an exemption in perpetuity or a 50 year fixed term exemption;
 - Reduce the bright-line test to five years for new builds for as long as they are able to claim interest deductibility;
 - All denied interest should be deductible at the time of sale where property is held on revenue account;
 - Developers be exempt, and remediation be included generally under the exemption;
 - Extend the application date of the new rules to 1 April 2022.

2. Introduction

- 2.1 Property Council welcomes the opportunity to submit on the Government's consultation document regarding the design of interest limitation rule and additional bright-line rules.
- 2.2 Property Council's purpose is "Together, shaping cities where communities thrive". We believe in the creation and retention of well-designed, functional and sustainable built environments which contribute to New Zealand's overall prosperity. We support legislation that provides a framework to enhance economic growth, development, liveability and growing communities.
- 2.3 Property is currently New Zealand's largest industry with a direct contribution to GDP of \$29.8 billion (13 per cent). The property sector is a foundation of New Zealand's economy and caters for growth by developing, building and owning all types of property.

- 2.4 Property Council is the leading not-for-profit advocate for New Zealand's largest industry- property. Connecting people from throughout the country and across all property disciplines is what makes our organisation unique. We connect over 10,000 property professionals, championing the interests of over 600 member companies have a collective \$50 billion investment in New Zealand property.

3. Overview

- 3.1 Property Council does not support the proposed design of the interest deductibility limitation rule or the changes to the bright-line rules for residential land . Our view is that changes to interest deductibility will reduce supply and put pressure on developers and landlords. Extra costs on landlords may lead to fewer rentals being available, and reducing incentives for developers to build new houses may lead to fewer affordable houses for New Zealanders.
- 3.2 It is also out of step with other international jurisdictions who similarly battle with housing affordability challenges.
- 3.3 Emerging asset classes like Build-to-Rent are at risk of being deemed unviable by domestic developers due to these changes.

4. Build-to-Rent

- 4.1 Property Council recommends a specific carve out for Build-to-Rent (BTR) developments that would ensure certainty to developers and future owners have certainty. For clarity, Property Council defines Build-to-Rent as an asset specifically designed, constructed or adapted for long-term residential tenancies, accommodation comprised of a portfolio of minimum 50 self-contained dwellings and include some form of shared amenity, dwellings let separately but held in unified ownership and dedicated to residential tenancies for at minimum eight years, and professional and qualified management, with oversight under a single entity. We will continue to work with the Government on any definitional issues that may arise.
- 4.2 Property Council has been working constructively with the Ministry of Housing and Urban Development and others in a BTR reference group to help unleash its full potential. Our view is that Build-to-Rent is more akin to a commercial asset or like student accommodation and retirement villages. This matches up with other international jurisdictions we compare ourselves to. We have attached our briefing paper to Hon Megan Woods regarding BTR and its potential effects on New Zealand's housing market for your information.
- 4.3 As part of that work, recognising institutional barriers within New Zealand's tax and broader regulatory settings and helping identify solutions to them has been core to the success of the group so far. The activation of BTR will be a critical enabler to accelerate the supply and delivery of affordable housing across New Zealand – both affordable rental and affordable owner-occupier homes. It has the potential of being one of the largest contributors to new accommodation supply in New Zealand.
- 4.4 BTR does not compete with the secondary re-sale housing market in the first home buyers/affordable space. BTR is supplementary on the housing continuum that supports different needs and requirements. In terms of supply, BTR generally does not compete with the same land residential developments are. Most BTR developments are built on metropolitan and business mixed use and due to the

nature of BTR. BTR is viable because of its access to other commercial and retail spaces close to town centres which don't exist in predominantly residential areas. In both of these regards, BTR does not fit neatly in with the traditional residential asset class. If BTR is not exempt then it is not participating on a level playing field with other commercial uses who are competing for similar metropolitan and business mixed use zoned land.

- 4.5 If BTR is not recognised as a specific asset class, and is not explicitly exempt in perpetuity from the proposed interest deductibility changes, it is our view that BTR will not be feasible to grow and operate in New Zealand. This applies to all BTR products, both affordable and market ends.
- 4.6 We note that the consultation document proposes that new builds be exempt from the changes. However, internationally the reality is the new build market is driven in part by the success and development of the secondary re-sale market. It is our submission that they cannot be separated and the Government must support both in order to create a viable sector.
- 4.7 To many investors, New Zealand is seen as out of step with international best practice and impeded in our ability to attract capital and expertise to build and develop at scale and pace. This further diminishes that, and puts at risk the Government and private industry's ability to add supply across New Zealand and help fix New Zealand's housing crisis.
- 4.8 In our submission on the Overseas Investment Amendment Bill (No. 3), we recommended that the Government introduce an exemption and create a new asset class to allow foreign capital investment into New Zealand to specifically support BTR developments like is allowed for retirement villages and student accommodation. We further recommend the Government progress this work as a matter of urgency alongside their consultation on the proposed changes to interest deductibility rules.

5. Properties caught by the proposed rules

- 5.1 If the Government chooses to progress their proposed changes, Property Council recommends the following:
 - (a) That an apportionment approach be used to ascertain purpose for dual purpose properties, as opposed to a predominant use approach;
 - (b) That a carve out be created for purpose-built student accommodation; and
 - (c) That a carve out be created for serviced apartments

Apportionment versus predominant use

- 5.2 Property Council recommends using an apportionment approach when determining the tax treatment of dual purpose properties. Apportionment is a fairer, more accurate way of determining usage we believe an apportionment calculation allowing for interest deductions in relation to the business premises of a dual-purpose building is preferable over the all or-nothing approach.
- 5.3 Equally, we agree with the Government's position that the current rules regarding apportionment, which generally focus on time and space, should be used over developing new and potentially more complex and burdensome ones.

- 5.4 Using a predominant use approach likely leads to an “all or nothing” outcome, where there is the potential for mischaracterisation of usage to avoid particular tax treatment. Our tax settings should be encouraging mixed use developments across New Zealand. BTR is one example of a development which has both rental accommodation as well as commercial and retail spaces. In our view, an apportionment approach will encourage more of these developments which will allow more land to be available for affordable and market homes.
- 5.5 We think this aligns with approaches taken by the Government in other parts of their consultation process, particularly around exemptions for new builds.

Purpose-built student accommodation

- 5.6 We also support an exemption for purpose-built student accommodation on the basis that these particular student residential buildings do not compete with owner-occupied accommodation and would not typically be set up in a way that would be conducive to owner-occupation in the future.
- 5.7 We agree with using the existing regulatory framework in the Residential Tenancies Act 1986 as it will reduce the risk of abusing the exemption and is a neat avenue for targeting the specific carveout. While we understand the concern regarding exemptions creating an incentive to convert residential apartment buildings into student accommodation, we think this is overstated for two reasons.
- (a) Often student accommodation is necessarily more bespoke than residential apartment buildings and require different facilities and set ups. The cost of converting a residential apartment building into a student accommodation would probably exceed any benefit that might exist from an exemption.
 - (b) Often these buildings are situated significant distances from University or Polytechnic campuses, making that accommodation particularly unattractive from both a distance and safety perspective. The Universities of Otago and Canterbury are moving towards accommodation either on campus or very close to it.
- 5.8 This aligns with exemptions given to purpose-built student accommodation in other pieces of legislation, such as the Overseas Investment Act.

Serviced apartments

- 5.9 Property Council recommends an exemption for serviced apartments. The exemption for serviced apartments paragraph (b)(iii) of the definition of “dwelling” in section YA 1 of the ITA provides a good distinction between rental accommodation and serviced apartments. For the purposes of the ITA, a serviced apartment is accommodation for which paid services in addition to the supply of accommodation are provided to a resident, and in relation to which a resident does not have quiet enjoyment, as that term is used in section 38 of the Residential Tenancies Act 1986 (RTA). Section 38 of the RTA states that a tenant shall be entitled to have quiet enjoyment of the premises without interruption by the landlord or any person claiming by, through, or under the landlord or having superior title to that of the landlord. A serviced apartment, therefore, is more akin to a hotel or other commercial accommodation than residential rentals and should be treated as such.
- 5.10 We also disagree with the view that allowing owners of serviced apartments to claim interest deductions may lead to the conversion of regular apartments into serviced

apartments and a reduction in the effective housing supply. We submit that most owners of regular apartments gain a longer term benefit of keeping the apartments as such, and the increased compliance of converting them to serviced apartments would be a deterrent on most owners.

6. New build exemption

- 6.1 We agree that an exemption from the proposed interest limitation rules be made for new builds. We believe this exemption should be in perpetuity for the initial owners of the property. We also support an exemption for subsequent owners of new builds, with a preference for perpetuity as well.
- 6.2 If the Government is not minded to extend in perpetuity an exemption for subsequent owners, we believe an exemption should be granted for at least 50 years from the issuing of the CCC to minimise the effect on asset valuations which have to assume trading into the secondary re-sale market. Our view is that a 50 year exemption will provide the most certainty and assurance for subsequent owners.
- 6.3 We also support the Government investigating whether the exemption should stay with the building, and not the owner. In our view, there is merit to investigating whether an exemption should stay with the building rather than the owner for a fixed period like some Australian jurisdictions are considering.
- 6.4 We agree that existing apportionment principles should apply where a new build and a non-new build that are on the same title are purchased – i.e., an exemption would only apply to interest on the portion of the purchase price borrowing that relates to the new build.
- 6.5 We also agree that commercial to residential conversions should be included, for instance in situations when an office building that is converted into apartments, or a large commercial heritage building such as a harbour warehouse that is converted into townhouses. This should be treated similarly to subsequent owners of new builds, i.e. with a 50 year period from the date of completion. Property Council strongly believes regulatory settings should encourage as much as possible increasing supply.
- 6.6 We recommend reducing the bright-line test to five years for new builds for as long as they are able to claim interest deductibility. Our preference is that the bright-line test be five years across all residential property, including subsequent owners of new builds. Property Council's position is underscored by the low quantitative data supporting the idea many early owners "flip" houses as often as public discourse suggests.

7. Interest deduction on sales

- 7.1 Property Council recommends that where property is held on revenue account, all denied interest should be deductible at the time of sale (Option B). This reflects the nature of the sale and reflects the economic gain and loss. We agree that deducting at the time of sale when the gain is taxed ensures the owners actual income is taxed, and not overtaxed and overcomplicated.

- 7.2 We would also argue that a ten year bright-line test increases the opportunity for arbitrage. Our preference as stated in 6.3 would reduce the opportunity for arbitrage and deal with the concerns raised by the Government.
- 7.3 However, where property is held on capital account, Property Council supports Option F - no deduction should be allowed for denied interest up to amount of non-taxed gain, with excess deductible (subject to ring fencing). Sellers should get a deduction to the extent that their interest cost exceeds the capital gain, as effectively the interest cost relates to both the capital gain amount and the taxable income that has already been returned during the period of ownership.

8. Developer exemption

- 8.1 We support the Government's proposed exemption for property developers. We raised a number of points in support of such an exemption earlier regarding BTR. We agree that this should also be extended to include one-off developments.
- 8.2 Property Council's view is that this exemption should not be overcomplicated or complex. It should follow similar rules to the exemption proposed for new builds that if a development is increasing housing supply, then an exemption should be granted to support the Government's objectives. Our view is that a wider approach towards development exemptions should be favoured over carving out too many ways in which a development may not qualify for an exemption.
- 8.3 We also believe remediation should be included generally under the exemption. As well as increasing housing supply, the Government's goal of more warm, dry housing extends to existing as well as future supply. To that end, supporting landlords and owners to remediate and improve existing stock should be considered as an effective lever to encourage behavioural change. We think that an effective way to administer this could be via statutory declaration at the point when claiming the exemption.

9. Application date

- 9.1 Property Council recommends the Government push out the application date to after the parliament has passed the changes. We recommend deferring the application date, until 1 April 2022.
- 9.2 This will do three things which we think are important to the effectiveness of the regime:
- (a) It will provide IRD and other systems to ready themselves for a smooth and effective transition that does not cause unnecessary extra cost and burden;
 - (b) It will allow affected parties – developers, owners, landlords and tenants - to better understand and prepare for the changes so as to avoid confusion and non-compliance; and
 - (c) It will allow tax practitioners time to prepare and provide timely and accurate advice to their clients in preparation for the change.
- 9.3 For the benefit of the integrity of the tax system, taxpayers should not be required to make decisions and effectively take tax positions (for instance, for determining provisional tax obligations) based on legislation that has not been enacted.

- 9.4 Our view is always that rushed application can lead to un-intended consequences. There seems no strong public policy rationale to impose the regime quicker than our proposed timeline above.

10. Conclusion

- 10.1 Property Council is grateful for the opportunity to provide feedback on the design of the interest limitation rule and additional bright-line rules.
- 10.2 We do not support the proposed changes to interest limitation and additional bright-line rules. Property Council believes the Government can take alternative policy decisions to increase supply and cool speculation and price increases in the housing market. If the Government does choose to advance these changes, we believe the exemptions we have advocated for will somewhat reduce the likely chilling effect interest limitation will have on developments and ensure houses can still be built at scale and pace.
- 10.3 For any further queries contact Liam Kernaghan via email: liam@propertynz.co.nz or cell: 021 715 108.