Property Council New Zealand

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Submission on the Taxation (Annual Rates for 2021-22, GST, and Remedial Matters) Bill

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Taxation (Annual Rates for 2021-22, GST, and Remedial Matters) Bill

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 supplementary order paper number 64 ('SOP') to the Taxation (Annual Rates for 2021-22, GST, and Remedial Matters) Bill. 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 in perpetuity, including legitimate Build-to-Rent developments prior to 27 March 2021, and create an asset class that considers Build-to-Rent as a commercial asset rather than residential;
- Legislate a carve out 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 proposed changes to the interest deductibility rules as set out in the SOP to the Taxation (Annual Rates for 2021-22, GST, and Remedial Matters) Bill.

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 $41.2 billion (15 per cent). The property sector is a key 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 560 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 We agree with the Inland Revenue Department ('IRD') that:

- "additional taxes on rental housing are unlikely to be an effective way of boosting overall housing affordability."
- "it will put upward pressure on rents and may reduce the supply of new housing developments in the longer-term."
- "The benefit of increased housing affordability for first-home buyers is outweighed by negative impacts on rents and housing supply, high compliance and administration costs for an estimated 250,000 taxpayers, and the erosion of the coherence of the tax system."[1]

3.3 Property Council also agree with Te Tūāpapa Kura Kāinga – Ministry of Housing and Urban Development ('MHUD') in opposing limiting interest deductions because:

- "Of the negative impacts this could have on new housing supply if a new build exemption is not long enough."
- "Of the negative impacts it is likely to have on rents, rental churn, the provision of emergency, transitional and public housing, and the feasibility of purpose-built rentals."[2]

3.4 We note that IRD have expressed concern that "analysis has not been done on the impacts of the overall interest limitation policy in conjunction with non-tax measures that have recently been implemented or which are being considered" and "while a discussion document was produced concerning the general proposal, there has been very limited engagement on final design decisions and their overall coherence." [3]

3.5 Property Council's firm view is that such wide-ranging and fundamental changes to the tax system should not be done without substantial consultation and analysis of the benefits across the whole system. Many of the issues identified by submitters in relation to implementation and unintended consequences of changes to the tax system without a system-wide review have not been addressed.

3.6 There is no principled reason to rush these changes through. We recommend that a more thorough examination of the proposed changes to interest deductibility rules

1 https://taxpolicy.ird.govt.nz/-/media/project/ir/tp/publications/2021/2021-ris-interest-deductibility/2021-ris-interest-deductibility-pdf.pdf?modified=20210927011748&modified=20210927011748 – page 2

2 https://taxpolicy.ird.govt.nz/-/media/project/ir/tp/publications/2021/2021-ris-interest-deductibility/2021-ris-interest-deductibility-pdf.pdf?modified=20210927011748&modified=20210927011748 – page 3

3 https://taxpolicy.ird.govt.nz/-/media/project/ir/tp/publications/2021/2021-ris-interest-deductibility/2021-ris-interest-deductibility-pdf.pdf?modified=20210927011748&modified=20210927011748 – page 4

happen before the Government chooses to pass into law the changes to the Income Tax Act.

4. Build-to-Rent - General Comments (Need for an Asset Class)

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. We understand that a new asset class is not in scope for this bill but wish our comments on BTR to have this section as a foreword. For clarity, Property Council defines BTR 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 BTR 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 such us, the United Kingdom and Australia.

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. 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. BTR must access interest deductibility so it is 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 bill identifies 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 which has impeded in our ability to attract capital and expertise to build and develop at scale and pace. The proposed bill 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)[4], 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 this bill on proposed changes to interest deductibility rules.

5. Build to Rent – 20 years versus Perpetuity - Investment Case Fundamentals (returns and liquidity)

5.1 The investment case for BTR at scale in New Zealand relies on interest deductibility to enable effective leveraging through debt finance, enable liquidity and to compete with other large scale real estate assets. This is an unequivocally long-term driven asset class which needs long term certainty surrounding the ability to borrow and to claim tax relief on all interest.

5.2 A period of only 20 years to claim interest deductibility creates a fundamental and irrevocable flaw in the initial capital value appraisal of a BTR development which then materially worsens as the remaining period of potential interest deductibility ticks down for any asset.

5.3 The 'wasting asset' nature of 20 year interest deductibility cashflows will fundamentally undermine the asset class and put off a large number of long term investors who desire a longer horizon and who see the living sectors as a low return *but* growing investment sector. Figure 1 below shows the value relationship of an example BTR asset with interest deductibility permitted in perpetuity vs a limited 20 year period, based on net operating income rising annually by CPI at 2%.

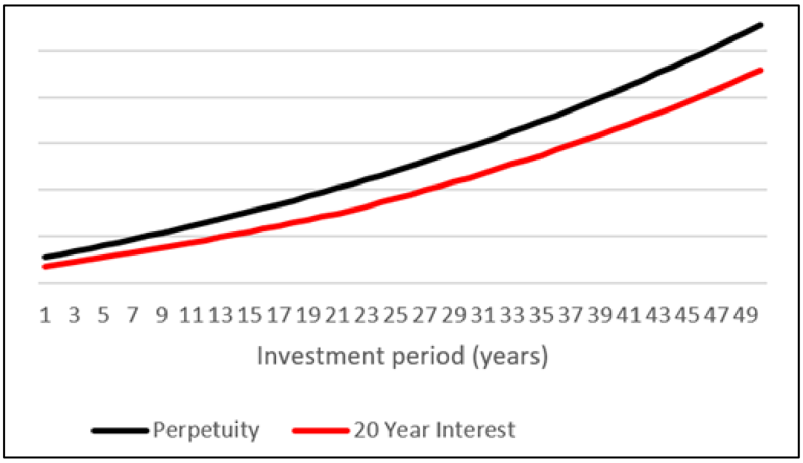

Figure 1: The gap in value between interest deductibility into perpetuity and for a fixed period of 20 years

5.4 By year 21, our modelling (in conjunction with JLL) shows that the capital value gap becomes substantial between an assumption of interest deductibility and no interest deductibility. Nearly **12.25%** of the value the scheme could have generated with the identical income stream if interest deductibility had been permissible in perpetuity is

[4] Property Council's submission on Overseas Investment Amendment Bill (No3). Retrieved from https://www.propertynz.co.nz/submissions/overseas-investment-amendment-bill-no3-submission

foregone. This gap is driven by a projected capitalisation rate expansion of **60 basis points** which is calculated to be needed to provide investors with the same return metrics they would have had if interest deductibility would have been permissible in perpetuity.

5.5 In addition, this mathematically identifiable gap has the consequence that it will all too often be unviable to develop BTR schemes in the first place as investors will need to reduce the capital value by nearly **6.75%** to cover the shortfall in long term after tax returns. Developers will not accept much-reduced low single digit developer profit margins (in our example, calculations to around **5.75%**) to take the risk of delivering what are substantial and complex buildings; that would be nonsensical.

5.6 For investors, the lack of interest deductibility will be a substantial psychological barrier for investors as it, essentially, starts a ticking clock on day one which just gets progressively less and less attractive until year 20. Seeing market values go comparatively backwards from already low income returns (irrespective of market movement) substantially restricts the secondary market which, inevitably and disproportionately impacts the primary market.

5.7 Nothing is more important than liquidity, investors will not invest (or will do so at a heavy discount) if they cannot see a clear path to exit. 20 year deductibility eliminates most of the investor pool. Many will be put off altogether, irrespective of the discount as they won't have a mandate to take on the risk.

5.8 This policy will keep our BTR sector much, much smaller than it could be and create a barrier to growth at a time we are trying to collectively open the market up.

5.9 As well as the financial aspects, the introduction of interest deductibility for BTR will also disproportionally impact the tangible benefits that the asset class could deliver for those who rent. This detriment to wellbeing outcomes must be considered as putting a time limit on rents will inevitably remove key certainty of tenure for those who live in these developments. Over the longer term this will inescapably end in them being treated like tenants prior to a vacant property sale rather than customers; something we are seeking to avoid as an industry to promote a wider choice of rental experience in NZ.

6. Build-to-Rent: Existing assets prior to 27 March 2021

6.1 We disagree that legitimate BTR developments built before 27 March 2020 in this bill are unable to achieve the same interest deductibility as those built after 27 March 2020.

6.2 BTR is anchored on the premise of long-term leases available to 'customers' (tenants) providing much needed certainty of tenure. The proposed legislative changes arbitrarily disadvantage those with existing legitimate BTR assets path prior to the bill's effective date of 27 March 2021 as they would not be able to attain a 'new build' definition.

6.3 If existing owners of legitimate BTR assets have their ability to access interest deductibility denied we would not want to see a perverse effect of customer's existing long-term leases terminated through selling of their homes should owners deem it financially necessary to do so.

6.4 We propose that the definition of a new build be extended to include properties that have been owned by a legitimate BTR developer/investor since inception (i.e. at the time the CCC issued) and the CCC has been issued in the 10 years prior to 27 March 2021. This timeframe generally aligns with other tax rules for developers holding buildings on capital account and GST treatment on retained residential dwellings. This reduces complexity in the tax system and promotes confidence in the tax system to reduce the impact of retrospective changes in tax rules.

7. Exemption for serviced apartments

7.1 If the Government chooses to progress the bill, Property Council recommends that a carve out be created for serviced apartments.

7.2 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.

7.3 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.

8. New build exemption

8.1 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.

8.2 If the Government is not willing 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 minimize 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.

8.3 We agree that existing apportionment principles should apply where a new build and an existing build 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.

8.4 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.

8.5 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.

9. Interest deduction on sales

9.1 Property Council recommends that where property is held on revenue account, all denied interest should be deductible at the time of sale. 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.

9.2 We would also argue that a ten year bright-line test increases the opportunity for arbitrage. Our preference in 8.3 (above) would reduce the opportunity for arbitrage and deal with the concerns raised by the Government.

9.3 However, where property is held on capital account, 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.

10. Developer exemption

10.1 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.

10.2 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.

10.3 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.

11. Application date

11.1 Property Council recommends the Government push out the application date to after parliament has passed the changes. We recommend deferring the application date, until 1 April 2022.

11.2 This will do three things which we think are important to the effectiveness of the regime:

(a) It will provide the 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.

11.3 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.

11.4 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.

12. Conclusion

12.1 Property Council is grateful for the opportunity to provide feedback on the design of the interest limitation rule and additional bright-line rules.

12.2 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.

12.3 For any further queries contact Leonie Freeman via email: leonie@propertynz.co.nz

Yours sincerely,

Leonie Freeman
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