



CHARTERED ACCOUNTANTS
AUSTRALIA + NEW ZEALAND

DavidCo Limited
CHARTERED ACCOUNTANTS

Level 2, Shortland Chambers
70 Shortland Street, Auckland
PO Box 2380, Shortland Street
Auckland 1140
T +64 9 921 6885
M +64 21 639 710
E arun.david@davidco.co.nz
W www.davidco.co.nz

WEEKLY COMMENT: FRIDAY 13 MAY 2022

1. The *Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Act 2022* (“the March 2022 Tax Act”), which received the Royal assent on 30 March 2022, contains the new rules on interest deductibility for residential properties and the corresponding changes to the bright-line test for taxing disposals of residential properties. Inland Revenue issued *Special Report on Public Act 2022 No 10* (“the March 2022 SR”) on 31 March 2022 covering the rules limiting interest deductibility and the additional bright-line test rules.
2. Last week I looked at the overview of the interest limitations, the meaning of disallowed residential property (“DRP”) and the exceptions listed in schedule 15 as “excepted residential land”. This week I look at the exemptions for “allowed property”, being residential property that is not excepted, but to which the interest limitation rules nevertheless do not apply **to the extent to which** the land is used for the relevant purpose.

Exemptions for allowed property

3. Section DH 4 lists the types of land that are not subject to the interest limitation rules in Subpart DH as follows:
 - (a) Section DH 4(1) provides that subpart DH does not apply to interest incurred by a person to the extent to which it is incurred on “new build land” for 20 years – see paragraph 4 below;
 - (b) Section DH 4(2) provides that subpart DH does not apply to interest incurred by a person to the extent to which it is incurred in relation to a land business described in s CB 7 – see paragraph 10 below;
 - (c) Section DH 4(3) provides that subpart DH does not apply to interest incurred by a person to the extent to which it is incurred in relation to land that is or was subject to the person’s undertaking or scheme involving development, division, or building for the purpose of creating new build land – see paragraph 17 below;
 - (d) Sections DH 4(4), (5) and (6) contain exemptions for emergency housing, council housing and Kainga Ora-Homes – see paragraph 19 onwards below.

New build exemption

4. Section DH 4(1) provides that subpart DH does not apply to interest incurred by a person to the extent to which it is incurred on “new build land” before the date that is 20 years after the earliest of the following dates for the new build land:

- (a) The date on which the code compliance certificate (“CCC”), issued under the Building Act 2004, described in s DH 5(7) is issued;
 - (b) The date that, in the records of a local authority or building consent authority, the relevant conversion or remediation is recorded as having been “completed”, in the cases provided in s DH 5(7)(d) and (e);
 - (c) The date that the relevant building work is entered into the records of a local authority or building consent authority as “substantially completed”, in the case of a CCC described in section DH 5(7) being issued subject to a building consent waiver or modification under clause B2.3.1 of the Building Code under the Building Act 2004.
5. The exemption runs for a 20-year period from the relevant start date listed above and applies to all owners during that period – the initial owner and all subsequent purchasers.
6. No changes have been made to the residential rental loss ring-fencing rules in Subpart EL. This means that these rules continue to apply as they currently do to interest deductions incurred in relation to rental properties.
7. “New build land” is defined, in s DH 5(7) as:
- (a) Land to the extent to which it has a place that is configured as a self-contained residence or abode, if a code compliance certificate has been issued on or after 27 March 2020 evidencing that the place was added to the land or converted into a residence or abode (for example, converting an existing home into two or more self-contained residences, or converting a commercial building into one or more self-contained residences – providing a CCC is received on or after 27 March 2020); and
 - (b) Including land exclusively used by residents of the place and also a reasonable proportion of shared areas of land, appurtenant to the place – Inland Revenue notes the apportionment must be “on a fair and reasonable basis”;
 - (c) Land for which there is an agreement that a place that is configured as a self-contained residence or abode will be added to the land and a code compliance certificate will be issued on or after 27 March 2020 evidencing that the place was added to the land – for example, “off the plans” purchases (but this category of new build land does not qualify for the 5-year bright-line test – which will be discussed in a *Weekly Comment* in about 4 weeks’ time);
 - (d) Land that has a place that was a hotel or motel, to the extent to which, by a conversion, it becomes places that are configured as self-contained residences or abodes, and the conversion is recorded in the records of a local authority or building consent authority as having been “completed” on or after 27 March 2020 (hotels and motels are already used for short-stay accommodation, and they often already have cooking facilities and bathrooms, therefore, less work may be required to convert a hotel or motel into self-contained residences, which may mean no CCC is issued once the conversion is completed, therefore, an exception to the CCC requirement applies for hotels and motels that are converted into self-contained residences);
 - (e) Land to the extent to which it has a place that is configured as a self-contained residence or abode, if the place was removed from the earthquake prone buildings register on or after 27 March 2020, and:

- (i) A CCC has been issued on or after 27 March 2020 evidencing that building work to remediate the place is complete;
 - (ii) The completion of the building work to remediate the place is recorded in the records of a local authority or building consent authority as having been “completed” on or after 27 March 2020 and as having been verified by a suitably qualified engineer;
 - (f) Land to the extent to which it has a place that is configured as a self-contained residence or abode, if the place was not previously weather-tight and a CCC has been issued on or after 27 March 2020 evidencing that at least 75% of the place’s cladding has been replaced (it does not matter whether the residence is stand-alone or part of an apartment block).
8. The inclusion of the words “to the extent” means that sometimes interest will need to be apportioned because only a portion of the interest a taxpayer incurs qualifies for an exemption:
- (a) Apportionment will only be required where the interest incurred partially qualifies for an exemption - for example, where a loan is for a parcel of land that has both a new build on it and an older house that was built some time ago, only the interest that relates to the new build portion of the land would qualify for the new build exemption;
 - (b) Alternatively, there could be one loan that relates to two different parcels of land, one of which is new build land, while the other is subject to interest limitation, in which case, only interest incurred in relation to the parcel of land that is new build land would qualify for the new build exemption;
 - (c) Where apportionment is required, existing apportionment principles must be applied, and Inland Revenue notes on page 54 of the March 2022 SR that any reasonable apportionment method can be used – this can include a valuation-based apportionment method or a land area apportionment method.
9. Inland Revenue notes that:
- (a) ‘Self-contained’ is not explicitly defined in the legislation, but it is intended to mean a place that is able to be lived in by a single household, without that household having to share essential facilities, such as a kitchen or bathroom, with another household;
 - (b) Land that has a place on it that was not previously self-contained, such as a sleepout, may qualify as new build land if the place later becomes self-contained;
 - (c) Even if some areas of a property are shared with other household units, a residence may still be considered self-contained as long as it has its own essential facilities - for example, a residence could be considered self-contained even if it shares the following facilities/areas with other residences/places:
 - (i) A landing or entranceway;
 - (ii) Laundry facilities;
 - (iii) Recreational facilities, such as a pool or a gym;
 - (iv) Outdoor areas, such as a driveway or garden;

- (v) Shared utilities connections such as power and water;
- (d) The size of the house and the construction materials used are irrelevant;
- (e) Proof that a self-contained residence has been added will generally be the CCC, however, for hotel/motel conversions and earthquake prone buildings that are remediated, other records held by a local authority or building consent authority can be used;
- (f) The acquisition date of the land is irrelevant – it is when the CCC is issued that is important;
- (g) “Added to the land” includes where:
 - (i) A new residence is constructed on the land;
 - (ii) A modular home is added to the land; and
 - (iii) An older home is relocated onto the land. – for example, if a house is shifted from one location to another on the land and a CCC is issued evidencing the residence added to the new location – however, if this is just to gain the benefit of the new build exemption or the 5-year bright-line test, it would be considered tax avoidance;
 - (iv) There is an existing residence on the same title;
 - (v) The new residence added is attached to another residence on the land.

Land business exemption

10. Section DH 4(2) provides that subpart DH does not apply to interest incurred by a person to the extent to which it is incurred in relation to a land business described in s CB 7, being a business of:
 - (a) Dealing in land;
 - (b) Developing land;
 - (c) Dividing land into lots; and
 - (d) Erecting buildings.
11. If a person does not acquire land for a land-related business but later forms an intention to develop the land, the land business exemption will not apply, and the person will need to meet the requirements of the development exemption to avoid the application of the interest limitation rules (see paragraph 17 below).
12. Inland Revenue notes on page 49 of the March 2022 SR that the exemption from the interest limitation rules:
 - (a) Commences when the land is acquired;
 - (b) Ends when the taxpayer’s s CB 7 land business ceases;
 - (c) Continues to apply as long as the land business continues in relation to interest on a loan not fully repaid upon the sale of land to which s CB 7 applied;

- (d) Does not transfer to subsequent purchasers, however, subsequent purchasers will qualify for the exemption if they themselves meet the criteria for the land business exemption;
 - (e) Applies to interest for all land to which s CB 7 applies, even if there is no active development, division, or building work occurring on the land at the time.
13. Interest that could be tax deductible includes interest incurred on borrowings that relate to:
- (a) Acquiring land;
 - (b) Developing or subdividing the land;
 - (c) Constructing or installing a new build on the land (see paragraph 4 onwards above for the explanation of “new build land”);
 - (d) Land holding costs (such as rates and insurance);
 - (e) Renovating, maintaining, or repairing a new build.
14. A unique feature of the land business exemption is that where a taxpayer’s s CB 7 land business involves remediating or renovating older houses for sale, the exemption will also apply to interest incurred on borrowings used in relation to that business. (The development and new build exemptions do not apply to interest incurred on remediating or renovating non-new builds, except to the extent the repairs or renovation work relate to remediating an earthquake prone or leaky building – see paragraph 7 above.)
15. The inclusion of the words “to the extent” means that sometimes interest will need to be apportioned.
16. If a taxpayer holds a mixture of s CB 7 and non-section CB 7 land, the land business exemption will not apply to all the taxpayer’s land - the exemption only applies to the s CB 7 land held by the taxpayer.

Land development exemption

17. Section DH 4(3) provides that subpart DH does not apply to interest incurred by a person to the extent to which it is incurred in relation to land that is or was subject to the person’s undertaking or scheme involving development, division, or building for the purpose of creating new build land. The exemption:
- (a) Commences when the person’s undertaking or scheme to develop, subdivide or build on the land for the purpose of creating new build land begins;
 - (b) Ceases for the person to the extent to which the land becomes new build land owned by the person (and the new build exemption applies instead) - land would generally become ‘new build land’ when a CCC is issued for a self-contained residence or abode that has been added to the land, provided the CCC is issued on or after 27 March 2020;
 - (c) Could potentially continue to apply if the development is sold at a loss such that the proceeds were insufficient to repay the debt, however, in most cases, interest will not be deductible after the land is disposed of because the nexus test will not be met;

- (d) Does not transfer to subsequent purchasers, who might themselves qualify if they meet the criteria for the development exemption.

18. Inland Revenue notes that:

- (a) The existing meaning of “undertaking or scheme”, as used in s CB 12, applies, which is an undertaking or scheme is a plan, design or program of action devised to attain some end result;
- (b) For the development exemption, it is sufficient to demonstrate a coherent plan or purpose that involves a series of steps to create new build land.

Social, emergency, transitional, and council housing exemptions

19. Sections DH 4(4), (5) and (6) contain exemptions for emergency housing, council housing and Kainga Ora-Homes as follows:

- (a) Subpart DH does not apply to interest incurred by a person for land, to the extent to which the land is used by a registered community housing provider under the Public and Community Housing Management Act 1992, by a department listed in schedule 2, part 1 of the Public Service Act 2020, or by Kāinga Ora–Homes and Communities and its wholly-owned subsidiaries, solely for 1 or more of the following:
 - (i) Social housing, as defined in s 2 of the Public and Community Housing Management Act 1992;
 - (ii) Temporary accommodation for people in need while they seek, or are assisted in finding, more permanent accommodation;
 - (iii) Accommodation for people in need (to cover accommodation not otherwise covered, which includes, for example, housing used by Oranga Tamariki to provide accommodation for tamariki and rangatahi);
 - (iv) Services connected with housing or accommodation as described above – Inland Revenue notes that this is to ensure a residential property that also provides wraparound services (such as onsite counselling or therapy) is not inappropriately disqualified from being eligible for the exemption;
- (b) Subpart DH also does not apply to interest incurred by a person for land, to the extent to which the land is used by a council-controlled organisation, as defined in s 6 of the Local Government Act 2002 (as opposed to the definition in s YA 1), or a local authority, solely for 1 or more of the following:
 - (i) Housing for people assessed by a local authority as being eligible for accommodation at less than market rental;
 - (ii) Services connected with such housing (to ensure that the provision of wraparound services in connection with council housing does not disqualify a property from being eligible for the exemption);
- (c) Subpart DH also does not apply to Kāinga Ora–Homes and Communities and its wholly-owned subsidiaries.

20. Inland Revenue notes that the exemption in s DH 4(4) for social and emergency housing only applies to the extent to which a given property is used:

- (a) By one of the entities listed in section DH 4(4) (a qualifying entity); and
- (b) For one or more of the purposes listed (i.e. social housing, temporary accommodation, accommodation for people in need and connected services).

21. Inland Revenue notes, in relation to the social and emergency housing exemption, that:

- (a) If a property satisfies one of the above two conditions but not the other, it is still subject to interest limitation - for example, if a house is rented out by a community housing provider at normal market rent and not as social housing, the exemption from the interest limitation rules would not apply;
- (b) The whole property must be used for one or more of the listed purposes to qualify for the exemption - if only one room in a property is rented by a qualifying entity and the other rooms are rented to third parties, the exemption would not apply;
- (c) The exemption applies on a property-by-property basis, therefore, if there are multiple buildings on a single piece of land (residential or commercial) and only one of the buildings is used for social, emergency or transitional housing, the exemption is only available for that particular property, and the person claiming the interest deductions may need to apportion their interest expense accordingly;
- (d) The entity that owns or rents the property does not need to be the same entity that provides the social, emergency or transitional housing - for example, one entity may be responsible for managing the property portfolio, but it may contract out the client relationship to another entity, in this case the exemption would still be available;
- (e) A taxpayer who leases their property to a qualifying entity for a listed purpose can qualify for the exemption for the duration of the lease, even if they are not a qualifying entity themselves and have no interaction with the individual tenant, however, the exemption does not apply to private property owners who lease their properties directly to low-income tenants, such as tenants in receipt of an accommodation supplement;
- (f) The exemption covers periods of vacancy between social housing tenants if the property continues to be under lease to a qualifying entity during that time - in the case of social housing, the definition in the Public and Community Housing Act 1992 includes premises that are "to be let" as community housing by a CHP or as Kāinga Ora housing;
- (g) In contrast, if a disallowed residential property is occasionally rented by a qualifying entity to provide emergency or transitional housing, but no exclusive lease exists for the property, periods of vacancy would not be covered by the exemption.

22. Inland Revenue notes, in relation to the council housing exemption, that:

- (a) A private landlord who leases their property to a local authority or CCO for the provision of council housing can qualify for the exemption for the duration of the lease, even though they are not a local authority or CCO themselves and have no interaction with the individual tenant, however, the exemption does not apply to private property owners who lease their properties directly to low-income tenants;

- (b) As with the social, emergency, and transitional housing exemption, the whole property must be used for council housing (including services provided in connection with council housing) to qualify for the exemption - if only one room in a property is rented by a local authority or CCO and the other rooms are rented to third-party individuals, the exemption in section DH 4(5) would not apply;
23. Interest incurred on a property would still be subject to interest limitation if the land is used by a local authority or CCO but not used for council housing – for example, if a CCO provides rental housing at market rates.



Arun David, Director,
DavidCo Limited