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 27 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 relating to interest deductibility for residential properties and the corresponding changes to the bright-line test. Inland Revenue issued *Special Report on Public Act 2022 No 10* ("the March 2022 SR") on 31 March 2022 on interest limitation and additional bright-line test rules.

2. Over the past three weeks, I have reviewed the meaning of disallowed residential property ("DRP") and "excepted residential land", the exemptions for new builds, land businesses, land developments and social, emergency and council housing, grandparented transitional loans and grandparented residential interest, valuation rules for the purposes of subpart DH, simplified interest limitation for a loan drawn down in tranches, and rollover relief for grandparented loans. This week I conclude my review of the interest limitation rules by looking at their application to companies, interposed entities, mixed use assets, treatment upon disposal of DRP and specific anti-avoidance rules.

Application to companies

3. Section DH 3 states that Subpart DH applies to a company if:

   (a) It is a close company (defined in s YA 1 as a company with 5 or fewer natural persons or trustees who own more than 50% of the company) and is not an "exempt Maori company";

   (b) It is not a close company and is a "residential land company" that is not a member of a wholly-owned group;

   (c) It is not a close company and is a "residential land wholly-owned group member".

4. If the interest limitation rules apply to a company, it must trace its borrowings to identify interest it has incurred for DRP. It is denied a deduction for that interest unless an exemption applies.

5. An "exempt Maori company" is a company that is a Maori authority or eligible to be a Maori authority, or is wholly owned by a Maori authority or a company or trust that is eligible to be a Maori authority, providing it is not a "residential land company" or a "residential land wholly-owned group member".

6. Inland Revenue notes that the exclusion for an "exempt Māori company" recognises that, while an exempt Māori company may legally be a close company, it is, in substance, a

company for the benefit of, and accountable to, a very large number of individuals. In terms of control and governance, an exempt Māori company is very different to a typical close company.

7. A close company does not have to consider DRP held as a percentage of total assets. If any DRP is held, the interest limitation rules apply and its borrowings must be traced.

8. A "residential land company" must determine DRP held as a percentage of total assets and borrowings need only be traced if the percentage is 50% or more.

9. A "residential land company" is defined in s DH 5(8) as meaning a company for which, under the valuation rules discussed in last week's *Weekly Comment*, at any time during the income year:

   (disqualified property + indirect disqualified property) ÷ total assets = 50% or more

   (a) "Disqualified property" is the value of the company's property that is DRP, other than land subject to the land business or development, division or building exemption in s DH 4(2) and (3);

   (b) "Indirect disqualified property" is the value of shares that the company holds in other companies that are residential land companies;

   (c) "Total assets" is the total value of the company's assets.

10. A "residential land wholly-owned group member" is defined in s DH 5(10) as meaning a company that is a member of a wholly-owned group of companies for which, under the valuation rules discussed in last week's *Weekly Comment*, at any time during the income year:

    (disqualified property + indirect disqualified property) ÷ total assets = 50% or more

    (a) "Disqualified property" is the value, on a consolidated basis of the wholly-owned group's property that is DRP, other than land subject to the land business or development, division or building exemption in s DH 4(2) and (3);

    (b) "Indirect disqualified property" is the value of shares that the wholly-owned group holds in non-group companies that are residential land companies;

    (c) "Total assets" is the total value, on a consolidated basis, of the wholly-owned group's assets.

11. "Disqualified property" excludes land subject to the land business or development exemptions, but includes land subject to the new build exemption (refer to *Weekly Comment* 13 May 2022 for an explanation of these exemptions). Inland Revenue states that new build land is included in disqualified property in order to avoid complications that could arise from having to distinguish:

    (a) New builds from old builds in a company that has both; and

    (b) New builds for which the 20-year exemption has run out from those still subject to the exemption.

12. "Indirect disqualified property" does not require companies to look through chains of companies to work out the precise amount of disqualified property held indirectly. Companies only need to consider the value of any shares they hold in other companies that are residential land companies.

13. Only companies that are in wholly-owned groups will need to consider the "residential land wholly-owned group member" requirements. Such companies must determine whether the 50% threshold for direct plus indirect disqualified property has been met on a consolidated basis.

Interposed residential property holder

14. A person is denied a deduction, under s DH 8(1)(c), for interest incurred to acquire an ownership interest in, or become a beneficiary of, an interposed residential property holder. An "interposed residential property holder" ("IRP holder") is defined in s DH 5(6) as meaning:

    (a) A shareholder in a close company which has, at the end of a quarter in an income year, an interposed residential property percentage of more than 10%;

    (b) A shareholder in a company that is not a close company which has, at any time in the income year, an interposed residential property percentage of more than 50%;

    (c) The trustees of a trust which has, at any time in the income year, an interposed residential property percentage of more than 10%, and the relevant person is a direct or indirect beneficiary.

15. An IRP holder can be a company or a trust that is not a unit trust (as unit trusts are companies for tax purposes). The interposed entity rules do not generally apply to LTCs and partnerships that have DRP (although an exception may apply if an interposed close company elects to become an LTC). Under the LTC and partnership rules, LTCs and partnerships are treated as transparent, and a person with an ownership interest in the LTC or partnership is treated as directly holding any DRP that the LTC or partnership may hold (in proportion to their effective look-through interest or partnership share).

16. The interposed entity rules apply when a person incurs interest to acquire an ownership interest in a company or to become a beneficiary of a trust, and the company or trust has an interposed residential property percentage over the relevant threshold.

17. "Interposed residential property percentage" ("IRP percentage") is defined in s DH 6, for an interposed residential property holder, as the amount calculated using the following formula:

    Disqualified assets ÷ total assets

    (a) "Disqualified assets" is the value of the person's DRP excluding:

        (i) Land subject to the new build, land business or development, division or building exemptions in s DH 4(1), (2) and (3); and

        (ii) For a close company, mixed-use assets subject to subpart DG;

    (b) Total assets is the value of the person's assets;

(c) If the person is a company, "disqualified assets" and "total assets" include assets held by lower tier companies attributed according to the shareholding percentages held in the lower tier companies – note that this special tracing rule in s DH 6(3) uses the existing look-through rule in s YC 4, but treats the company as the ultimate shareholder;

(d) If a close company becomes an LTC, the status of an LTC owner as an interposed residential property holder remains unaffected in relation to a loan taken out before the company became an LTC.

18. The total deduction denied in a year, for interest incurred as the owner, or to become an owner, of an IRP holder that is a close company is an apportioned amount calculated quarterly and summed for the entire year:

    (interposed interest incurred in the quarter) x (IRP percentage at the end of the quarter)

19. The formula:

    (a) Applies to shareholders in a close company with an IRP percentage of more than 10% at the end of a quarter in an income year - the shareholders in such a close company are IRP holders;

    (b) Does not apply to a shareholder in a close company with an IRP percentage of 10% or less - Inland Revenue notes that the 10% de minimis threshold ensures that shareholders of close companies with very small amounts of DRP as a proportion of their total assets do not have to apply the interposed entity rules.

20. In contrast, for a non-close company, the IRP holder rules:

    (a) Apply only if the company has, at any time in the income year,. an IRP percentage of more than 50%, in which case, the shareholders in the company are IRP holders; and

    (b) Result in the denial of all deductions for interest incurred to acquire an ownership interest in the company – Inland Revenue notes this is a simplification measure to avoid the apportionment approach which would be much more complex for a non-close company.

21. For a trust (other than a unit trust, which is a company for tax purposes), the IRP holder rules:

    (a) Apply to a person who is a direct or indirect beneficiary of the trust if the trust, at any time in the income year, has an IRP percentage of more than 10%; and

    (b) Result in the denial of all deductions for interest incurred to become a beneficiary of the trust – Inland Revenue notes that an apportionment approach would usually be impossible, but also notes that, in practice, it would be very uncommon for a person to incur interest to become a beneficiary of a (non-unit) trust.

22. The interposed entity rules do not apply to persons who borrow to acquire shares in an LTC or to acquire a partnership share in a partnership. LTCs and partnerships are transparent for tax purposes, and:

    (a) If a person incurs interest to acquire shares in an LTC, the person is treated as incurring interest to acquire any DRP held by the LTC in proportion to their effective look-through interest; and

(b) If a person incurs interest to acquire a partnership share, the person is treated as incurring interest to acquire any DRP held by the partnership in proportion to their partnership share.

23. If a close company elects to become an LTC:

(a) Section DH 6(4) contains a special rule which provides that, for the purposes of the interposed entity rules, a loan taken out before the company becomes an LTC is not affected by the company becoming an LTC; and

(b) The interposed close company rules apply to determine the amount of interest that is denied after the effective date of the LTC election;

(c) If a person borrows to acquire an ownership interest in the LTC after the effective date of the LTC election, the person will be treated as incurring the interest to acquire the DRP held by the LTC in proportion to the person's look-through interest, under the transparency rule in s HB 1.

Interest limitation and mixed use assets

24. The interest limitation rules apply to determine whether the amount of interest apportioned to the income-earning use of a residential property mixed use asset, either under Subpart DG or otherwise, is deductible.

25. Section DG 2(3B) states that a person is allowed a deduction for interest incurred for DRP:

(a) To the extent to which the deduction is allowed under Subpart DG; and

(b) The deduction is not denied under Subpart DH.

26. Therefore, for DRP, the income-earning percentage calculated under s DG 9, which would be deductible under s DG 8(1), is denied a deduction under s DH 8 (and if it is grandparented residential interest, the deduction is progressively denied until 2025).

27. Sections DG 10(1) states that sections DG 11 to DG 14 provide for the apportionment of interest expenditure incurred by a company that has an asset to which this subpart applies, and by other companies that are in the same group of companies as the company, and by shareholders.

28. New s DG 10(1B) states that despite s DG 10 and sections DG 11, DG 12, and DG 13, for the purposes of applying those sections:

(a) Interest incurred in relation to DRP or to acquire an ownership interest in, or become a beneficiary of, an IRP holder is ignored; and

(b) The debt to which the interest described in paragraph (a) relates is ignored; and

(c) A close company must, for an asset that is DRP, exclude from the asset value determined for the asset the lesser of:

(i) The asset value that would otherwise be determined for the asset;

(ii) The amount of the company's debt under which the company incurs interest in relation to the asset.

29. Inland Revenue notes that, while it is not clear in the new legislation, it is intended that this interest will be apportioned using the formula in s DG 9, and an amendment to ensure this result should be introduced in the next available tax bill.

30. As noted in paragraph 17 above, for a close company, mixed-use assets are excluded from the definition of "disqualified assets" in s DH 6, so that such assets give rise to a loss of deduction for interest incurred by a shareholder only under the mixed use asset rules.

31. Section DG 11 applies when a close company has a mixed use asset and incurs interest expenditure. Effective from 27 March 2021, it applies only to interest expenditure incurred on or after 1 October 2021 that is not for DRP nor to acquire an ownership interest in, or become a beneficiary of, an IRP holder.

32. Section DG 11 to DG 13 relate to assets held in corporate structures. Inland Revenue notes that interest expenditure subject to those provisions does not relate to the asset under the tracing approach that applies for subpart DH. Instead, it is allocated to the asset under the "stacking" approach set out in sections DG 11 to DG 13. This means that the interest is not subject to denial under subpart DH.

33. For a close company:

    (a) Section DG 11 applies only if it has debt that is not traced to a DRP or an IRP holder;

    (b) If s DG 11 applies, any traced debt and associated interest is ignored; and

    (c) Subpart DH does not apply to interest determined as tax deductible under s DG 11 (regardless of whether it is allocated to DRP or not, because it is allocated under the stacking approach in s DG 11 and not the tracing approach).

34. Section DG 14 applies to non-corporate shareholders in a close company or a qualifying company when a net asset balance remains outstanding for an income year after applying the stacking approach in sections DG 11 to DG 13. New s DG 14(4) provides that the following are ignored for the purposes of applying s DG 14:

    (a) Interest, incurred by the person as shareholder in relation to shares of the company for which a deduction is denied under s DH 8; and

    (b) [The debt to which that interest relates] x [The quarterly IRP percentage in s DH 8(4)(b)]

Exempt income arising from foreign currency loans

35. New s CW 62C concerns income from foreign-currency loans used for DRP and states that income of a person under the financial arrangements rules is exempt income if the person:

    (a) Derives the income from a financial arrangement that is a foreign currency loan; and

    (b) Uses the loan proceeds for DRP; and

    (c) Is denied, by s DH 8(1), a deduction for interest incurred by the person under the financial arrangement.

Treatment of denied amounts upon disposal of DRP

36. Section DH 11(1) states that if a disposal of DRP is taxed under the 5-year or 10-year bright-line test, any interest disallowed under s DH 8, that would otherwise have been allowed, is treated as an addition to the cost of the property and will be deductible under s DB 23.

37. Note, however, that due to the interest being treated as an addition to the cost deductible under s DB 23:

    (a) The "anti-arbitrage rule" in s EL 20 will restrict the deduction under s DB 23 to the amount of bright-line income derived, and the remainder is suspended and carried forward to a later income year when income is derived under the land tax rules (Inland Revenue states this rule is to stop people voluntarily selling within the bright-line period to be able to deduct a net loss);

    (b) The addition to cost is for interest disallowed under s DH 8 – if the interest is not deductible under general principles, because the property was only privately used, it will not be added to the cost of the property under s DH 11(1) even if the gain on sale is taxed under the bright-line test.

38. If a disposal of DRP is not taxed under the bright-line test, but under some other tax provision, any interest disallowed under s DH 8, that would otherwise have been allowed:

    (a) Is allowed as a deduction in the year of disposal; and

    (b) Is subject to the allocation rules under subpart EL if the DRP is residential rental property for the purposes of the ring-fencing rules in subpart EL.

39. In this case, the interest previously denied under subpart DH retains its character as interest, and is not re-characterised as part of the cost of the property.

40. Application of the residential rental loss ring-fencing rules means the previously denied interest, and any other expenditure, is netted off against the residential income from the property or portfolio. "Residential income" is defined in section EL 3 and includes the rental income and any net land sale income from the property or portfolio. If the total deductions exceed the residential income, the treatment of the excess deductions (that is, the net loss from the property or portfolio) depends on whether the residential rental loss ring-fencing rules are being applied on an individual property or portfolio basis:

    (a) If the rules are being applied on a portfolio basis (that is, together with other properties), the net loss in the year of a taxable disposal is deferred and carried into the next income year to be deducted against later residential property income;

    (b) If the taxpayer is applying the rules on an individual property basis, the net loss is usually fully deductible in the year of the taxable disposal.

41. Note that interest that is deductible when incurred, for example, because the deduction is not denied under subpart DH, may be subject to the residential rental loss ring-fencing rules, in which case, it may not be automatically deductible in the year of disposal. The residential rental loss ring-fencing rules in subpart EL will apply to determine the timing of tax deductibility.

Specific anti-avoidance rules

42. New s GB 53B applies to ignore the effect of an increase or decrease in value that affects, or would affect the result of a calculation of a person's IRP percentage (see paragraph 17 above), if the increase or decrease is:

    (a) Caused by an action or omission that has, or would have the purpose or effect of defeating the intent and application of subpart DH;

    (b) Produced by an arrangement that has a purpose or effect of defeating the intent and application of subpart DH.

43. Inland Revenue notes that a change in value that defeats the intent and application of subpart DH could occur, for example, by a disposal shortly before a calculation date and a re-acquisition after that date. For example, a close company may dispose of DRP shortly before a quarterly calculation date so that its IRP percentage falls below the 10 percent threshold required for it to be an IRP holder. The company may then reacquire the same or similar DRP shortly after the calculation date.

44. When, under an arrangement, a person borrows money and on-lends it to an associated person at a lower rate than that at which the person borrowed it, new s GB 53C applies to treat the interest incurred by the person for the purposes of the tax deductibility rules in Part D as limited to and calculated using the lower rate, and ignoring the higher rate, if:

    (a) The associated person, or a person associated with the associated person, owns DRP; and

    (b) The arrangement has a purpose or effect, not being a merely incidental purpose or effect, of defeating the intent and application of subpart DH.

45. Inland Revenue notes that although the interest at the lower rate incurred by the DRP holder might be denied under subpart DH, the higher rate of interest paid by the on-lender on the borrowings that, in economic reality, funded the DRP might not be subject to any limitation in the absence of an anti-avoidance rule. The specific on-lending anti-avoidance rule in section GB 53C ensures that on-lending arrangements with a purpose or effect of lowering the amount of interest denied under subpart DH are not effective.

Arun David, Director,
DavidCo Limited