Tax Tips Alert | 24 March 2021

Government announces tax changes to address housing demand

The Government has announced a number of changes to tax rules, including extending the bright line test to 10 years and disallowing interest deductions on residential investment property, which are part of a wider package intended to help address housing affordability.

Ministers have described the proposed changes as removing tax "loopholes" benefiting property investors that are currently allowing them to outbid first home buyers and current homeowners looking to move into a new home.

In our view, the changes are blunt tools with potential unintended consequences when considered in the context of the established principles of tax policy design. Specifically, these changes when coupled with the new personal marginal tax rate of 39% further erodes the coherence of New Zealand's tax system and introduces additional complexity without a clear view of the long term effects of such changes on the tax system.

The changes come as data from the Real Estate Institute of New Zealand (REINZ) showed the median house price in New Zealand increased by $50,000 in the month of February (and $100,000 in Auckland) demonstrating the housing affordability problem that the Government is seeking to address.

Bright line changes

Extension of the bright line period

The bright line test applies to deem the sale of a residential property within the bright line period as having been bought with the intention of resale (and therefore any gain is subject to tax). The current bright line period is five years, having been extended from the initial two year period which applied when the bright line test was first introduced in 2015. The sale of a property which is used by the owner as their "main home" is not subject to the bright line test.

The changes announced today will extend the bright line period from five years to 10 years. Residential properties acquired on or after 27 March 2021 will be subject to income tax if disposed of within 10 years. For tax purposes, a property is generally acquired on the date a binding sale and purchase agreement is entered into. A property acquired on or after 27 March 2021 will be treated as having been acquired before 27 March 2021, if the purchase was the result of an offer the purchaser made on or before 23 March 2021 that cannot be withdrawn before 27 March 2021.

However, the 10 year bright line period will not apply to newly built homes, which will continue to be subject to a five year bright line period. The Government will undertake further consultation on the definition of a "new build", but the intention is that it should apply to include properties acquired within a year of receiving their code compliance certificate under the Building Act 2004.

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Main home test – change of use rule

The definition of a "main home" for the purposes of the bright line test will also be amended, by introducing a new "change of use" rule. The main home exclusion currently applies on an "all or nothing" basis. If a property was used mostly as the owner's main home for the bright line period, then it has been treated as having been the owner's main home for the entire bright line period. The newly announced "change of use" rule will effectively tax some of the gain made on a "main home" if it was not used as the owner's main home for more than 12 months at a time during the bright line period.

Any residential property that has been used as the owner's main home for the entire time they owned it will continue to be excluded from any bright line test. If the property is not used as a "main home" for a period less than 12 months (for example, if an owner takes a few months to move into a property), this period is still counted towards the owner's "main home days".

The new "change of use" rule will apply for residential properties that are subject to the 10 year bright line test (generally property acquired on or after 27 March 2021, including new builds). The new rule will treat the following amount as taxable income upon disposal of the property:

The sale price of the property, minus:

- The purchase price;
  - The cost of any capital improvements made by the owner of the property; and
  - The costs to buy and sell the property.
- The result is then multiplied by the proportion of the time the property was not being used as the owner's main home.

If a residential property was acquired on or after 29 March 2018 and before 27 March 2021, the existing main home exclusion rules will continue to apply (i.e. on an all-or-nothing basis).

What's next?

The bright line changes have been included as a Supplementary Order Paper to the Taxation (Annual Rates for 2020-21, Feasibility Expenditure and Remedial Matters) Bill, which is currently before Parliament and expected to be enacted before 31 March 2021.

The Government will consult on the definition of "new build".

Denial of interest deductions

Alongside the changes to the bright line test, the Government has also announced that interest deductions will be denied entirely for residential rental properties. The Government's view is that the ability to deduct interest payments is a "tax loophole" which provides speculators and investors with an unfair advantage against first home buyers. Tax policy officials have previously suggested that rental properties may be undertaxed compared to other asset classes given that a tax-free capital gain is often realised when the property is sold.

Under the new rules, interest payments on residential investment property acquired on or after 27 March 2021 will no longer be deductible from 1 October 2021. Interest deductions which relate to amounts borrowed on or after 27 March 2021 in respect of a property acquired before 27 March 2021 will also be disallowed from 1 October 2021.

Interest on loans for properties acquired before 27 March 2021 can still be deducted. However, the amount that can be deducted will be reduced over the next four years. This means that from the 2025–26 and later income years, interest payments will become totally non-deductible.

Finally, the proposals should not affect property developers, who will continue to be able to deduct their interest costs. The rationale for this is that property developers are subject to income tax on the sale of property. The new rules are also not intended to deny interest deductions for loans secured against residential property but used for non-housing business purposes.

The Government will conduct further public consultation on the detailed design of these new rules and legislation will be introduced shortly afterwards. The scope of the consultation will focus on how the new rules should apply to new builds, and whether interest should be deductible at the time of the sale if the property is subject to income tax on disposal (for example, under the bright-line test).

PwC comment

After the former Coalition Government (and the Prime Minister) ruled out recommendations from the 2018/19 Tax Working Group to tax capital gains, the Government reaffirmed at the 2020 election that it would not introduce a capital gains tax or introduce new taxes during this Parliamentary term. The Government's view is that the extension of the bright line period is merely an extension of existing tax settings and is therefore consistent with its election promises.

In our view, the Government's promises have led to the development of a number of ad-hoc measures that have eroded the coherence of New Zealand's tax system. The extension of the bright line period and the introduction of the "change of use" rule will add greater complexity to the taxation of land. The changes further move the capital-revenue boundary for residential property.

More worrying is the proposed changes to deny interest deductions for residential investment properties. When considered alongside other recently enacted changes such as the ring-fencing of rental losses, it intentionally makes the tax settings on residential investment property quite different to other investments by increasing the effective tax rate on rental income as compared to other business income.

The announcements, when combined with the 39% personal tax rate increase are steadily undermining the coherence of New Zealand's tax system. There is now an increasing range of possible tax outcomes for the same amount of income depending on the type of income, who has earned it and how and when it was earned. This significantly increases complexity as well as opening up the possibility of tax driving business decisions reducing the overall efficiency of the tax system.

Ministers have cited the unfairness of current tax settings as a rationale for the proposed changes and that's a valid concern. But the combined effect of the changes announced yesterday raise new issues for horizontal equity: the principle that people that are in the same position should pay the same amount of tax. Subjecting one class of investments to a different tax treatment than other investments goes against this principle. The Government's Tax Working Group did recommend a coherent response to some of these issues, but that was seen as not politically viable. So, in the end, some second or third best best tax policy tools have been deployed to try and help address a significant issue for New Zealanders – housing affordability.

If you would like any further detailed advice on what these announcements mean for you, please reach out to your usual PwC advisor.

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