KPMG

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Regular commentary from our experts on topical tax issues

Issue 1

5 year bright-line passes; rental loss ring-fencing proposal

Snapshot

The **Taxation (Annual Rates for 2017-18, Employment and Investment Income, and Remedial Matters) Bill** received Royal Assent on 29 March 2018. The Act makes changes signalled in previous taxmails (**here** and **here**), including new employee share scheme taxing rules. The Act also extends the "bright-line" period for taxing sales of residential property from 2 to 5 years. The 5 year test will apply to acquisitions on or after 29 March 2018.

On the same day, Officials released a **consultation document** on restricting ("ring-fencing") residential rental tax losses. Proposed to apply from the 2019-20 income year, rental losses will only be available to offset rental gains or taxable sales of the property. Special rules are proposed to deny investors interest deductions where a company, trust or partnership holds the residential rental property. Submissions on the rental loss ring-fencing proposal are requested by **11 May**.

Both the bright-line test extension and rental loss ring-fencing were part of the Labour Party's 2017 election tax policy.

The 5 year bright-line test applies where the "first interest" in land is acquired on or after 29 March 2018

In most cases, this will be when an unconditional sale and purchase agreement is entered into, not when the property is settled

The rental loss ring-fencing proposal does not distinguish between those with single and multiple properties. Losses will be restricted in both cases. This appears contrary to Labour's election policy

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What's changing?

Bright-line test extension

A supplementary order paper to the Employment and Investment Income Bill increased the bright-line test period from 2 to 5 years.

The 5 year period only applies if a person acquires a "first interest" in residential land on or after 29 March 2018. Inland Revenue's guidance states that this is generally the date a binding (i.e. unconditional) sale and purchase agreement is signed and executed by both vendor and purchaser. Therefore, those with binding sale and purchase agreements before 29 March, but settling after that date, should only be subject to the 2 year rule.

Rental loss ring-fencing

In summary, from the 2019-20 income year (with potential phasing in over two or three years):

- Residential rental tax losses will not be able to be offset against other income (for example, salary or wages or business income) to reduce the overall tax liability or to receive refunds of PAYE or other tax paid.
- The rules will apply to all "residential land" (e.g. land with a residential dwelling or capable of being developed for such) other than: a person's main home; property that is a "mixed-use asset" (which is subject to its own tax deductibility regime); and land that is held as part of a land dealing, development, division or building business (which results in it being on "revenue account").
- Rental tax losses from one property will be able to offset rental gains from another property, where multiple properties are owned. Any residual losses can be carried forward to offset future rental gains or taxable gains on sale of any residential land.
- Special rules will apply for residential land held through interposed entities (such as companies, trusts and partnerships), if this is more than 50% of the entity's assets (i.e. the entity is "residential property land rich"). The interest expense of an investor in the entity will be disallowed (i.e. carried forward for offset in future years) to the extent it exceeds dividends, interest or distributions received from the entity (these are deemed to be rental property gains) and the investor's other residential rental property gains or taxable gains on sale of any residential land.

Some initial observations

Both extending the bright-line test period and restricting rental tax losses were part of the Labour Party's 2017 **election policy**. The proposals should therefore not be a surprise. Whether specific tax rules for residential property investments are justified, from a tax policy perspective, is another matter. Opinions will diverge.

The document asks whether the rules could be phased in over two or three years. Labour's 2017 policy was for a five year transition period. It is not clear why the longer period is no longer considered appropriate. Phasing in would allow for better managing of the full impact of the loss restrictions, particularly if property investments are held through entities and need to be restructured.

The proposal will apply to those who hold single and multiple rental properties. Labour's election policy referred to the latter as "speculators" and implied the policy would apply to them only. That distinction is not made in the consultation document. This is consistent with what we would expect – it is difficult to argue the rule should apply to owners of multiple rental properties but not a single property under a broad base, low rate tax policy framework.

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(As an aside, a “speculator”, in our view, is someone who buys to sell rather than someone holding multiple assets. A speculator should therefore be taxable on their gains on sale. For such persons, rental loss ring fencing should not apply as they are not the target.)

The proposed rules for “interposed entities” are worth a close look.

The proposed restriction is on interest deductions of the investor in the interposed entity. (Rental losses of the land holding entity may be quarantined under the normal rule as well.) Specific interest allocation rules have been eschewed in favour of limiting investors’ personal interest deductions to the value of distributions received and their other rental gains or taxable land gains. This rule appears to deem any borrowing of the investor to be solely for investment in “land rich” entities. The effect is to deny a deduction for interest on borrowing to make other investments.

The rule may therefore require restructuring of investment holdings and borrowings to avoid potentially significant interest denial, in relation to non-land investments. This supports a phasing in of the rules to avoid a significant upfront tax cost.

The “interposed entities” rule appears to be aimed at closely-held entities (a family trust or company). However, there is nothing to suggest that investments in widely-held commercial residential leasing businesses will not be caught by the proposed restrictions. This means that investors may need to consider the effect of the rules on their investments in listed and unlisted property vehicles, in New Zealand and offshore.

Finally, the proposal overlaps with the Tax Working Group’s work. It has been asked to consider the impact of the tax system on housing affordability. As that is generally expected to include consideration of a capital gains tax, the complexity that a rental loss ring fencing rule will bring to the application and design of such a tax suggests that it should be deferred for consideration by the Group. You can read our taxmail on the Tax Working Group submission process **here**.

Employers take note...

The recently passed Tax Bill includes new tax rules for employee share schemes. These change the timing and value of the taxable benefit to employees and allows a corresponding deduction for the employer. These new rules will have effect for share benefits granted 6 months after the date of enactment of the Tax Bill (i.e. 29 September 2018). The Tax Bill also contains new “payday” PAYE information reporting requirements which are mandatory from 1 April next year.

For further information

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