Government announces drastic residential property tax reform

The Government has today announced a housing package containing significant tax reforms aiming to increase housing supply and remove incentives to curb so-called "rampant speculation".

The principal tax policy measures extend the residential bright-line test from five to ten years and remove interest deductions for residential property investors. Aspects of these changes will apply to taxpayers from 27 March 2021, four days after their announcement.

No more deductions for interest expenditure

By far the more controversial of the two proposals is the removal of interest deductions for residential property investors.

Currently a taxpayer can deduct the cost of interest expenditure incurred in the course of deriving income, for example, rental income.

The Government proposes to disallow interest deductions from 1 October 2021 for all residential property acquired on or after 27 March 2021. It will also disallow interest deductions for money borrowed after 27 March 2021 to maintain or improve property, even if the property was acquired before 27 March 2021.

For existing property investors with outstanding loans (ie for property bought and money borrowed before 27 March 2021), interest deductions will be phased out by 25% each year for the next four years. From 1 April 2025 and onwards, none of the interest expense will be deductible.

The Government has suggested that property developers, who would be expected to pay tax on the gains from the sale of their properties, will be able to continue to deduct interest expenditure.

This measure is likely to impact considerably on the after-tax profit on rental income derived by residential property investors. It will not otherwise change the way that property is taxed (or not) when it is sold.

Significantly, the Treasury advised the Government against proceeding with these proposals at this stage, due to "time constraints and lack of analysis".[1] However, the Government has announced it will consult on the detail of these proposals before introducing legislation in advance of their expected 1 October 2021 implementation date.

[1] The Treasury "Tax measures to moderate house price growth – extension of the bright-line test" *Regulatory Impact Statement* (5 March 2021), available at <treasury.govt.nz>.

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Bright-line period doubled

The second key reform announced by the Government is the extension of the residential bright-line test from five to 10 years.

The bright-line test currently requires income tax to be paid at a taxpayer's marginal tax rate on gains made from the sale of residential property within five years of its acquisition, subject to several exceptions. Among other exceptions, the bright-line test does not apply if the residential property is the taxpayer's "main home" or if it was acquired by inheritance.

The Government proposes to double the bright-line period to 10 years. The new 10-year period will apply to all residential property acquired on or after 27 March 2021. If sold within 10 years of acquisition (provided no exclusion applies), the taxpayer will derive assessable income on the proceeds of sale.

The bright-line proposals were introduced to Parliament today, in a Supplementary Order Paper to the Taxation (Annual Rates for 2020–21, Feasibility Expenditure, and Remedial Matters) Bill. The Bill is expected to pass into law by the end of March 2021.

The Supplementary Order Paper also included measures designed to limit the way the "main home" exclusion can be relied on by taxpayers. Currently, the exclusion applies if the property is used as a main home "for most of" the bright-line period. The proposed changes will take into account a period in which the main home criterion is not satisfied and, if that period exceeds a year, the bright-line period is effectively extended.

Consistent with its aim to increase housing supply, the Government has also proposed to provide preferential treatment to "new builds", which will only be subject to a five-year bright-line period. However, it has not yet determined how a "new build" will be defined, and such an exemption will not come into effect until after the 10-year period passes into law. Further consultation is expected on this aspect of the policy.

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