BUDDLE FINDLAY

Developers interested in deductibility?

Tony Wilkinson, Fiona Heiford, Maria Clezy

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As part of its plan to address the housing crisis, the Government announced in March 2021 that there would be a range of tax laws introduced in relation to residential properties held by investors. One of the biggest and most surprising changes was that interest accrued on loans related to residential investment properties would no longer be deductible from 1 October 2021. Deductions of this nature will be denied either in full (for properties acquired after 27 March 2021) or phased in over a period of four years (for properties acquired before 27 March 2021). We expect the draft rules to be introduced today, likely in a supplementary order paper to the current omnibus tax bill that was introduced earlier this month.

In June, Inland Revenue released a discussion document on, amongst other things, the general design of the interest limitation rules. We are yet to see the new interest deductibility rules, despite the proposed application date of 1 October. While the proposed change to the interest deductibility rules is significant, it is unlikely to have any impact on property development businesses. The new rules are intended to coexist with existing tax laws and so the current land and deductibility rules will continue to apply to property developers for land held as part of their development business. This means that property developers should be able to continue claiming interest deductions for funding on property that is owned by a development business. It also means that the existing limitations that apply to a person or a type of land will continue to apply. For example, the private limitation, which denies a deduction for any private expenditure, will still apply to deny deductions for expenditure incurred by a person who is undertaking development work on their family home.

However, this does not mean that the new rules will not be relevant to property developers as they will affect the purchasers of the properties that are being developed making new builds much more attractive. They are also likely to apply to land not held for the property development business.

We discuss these issues below.

The new build exemption

The interest deductibility rules are primarily aimed at Mum and Dad investors who are expecting capital gains on residential property investments while receiving deductions for interest on the funding of those properties. The rules are intended to make such investments less attractive by denying deductions for interest expenditure on the funding for those properties. However, the Government recognised that an important part of the housing crisis response was to increase the housing stock supply. So, the Government has decided that certain types of housing that are deemed to be a 'new build' for the purposes of the interest deductibility rules will be exempt from those rules under the new build exemption. This means that interest on funding relating to new builds will still be deductible for the owner of that property for a yet to be determined period of time.

While it is generally expected that a property will be eligible for the new build exemption if it is acquired within 12 months of the code of compliance certificate being issued, Inland Revenue has indicated that there will be transitional rules for properties where the code of compliance certificate was issued prior to 27 March 2021 and the property was acquired on or after 27 March 2021.

Developers wishing to market their properties widely will want to ensure that the property will be eligible for the new build exemption, otherwise it may limit potential purchasers by being less attractive to residential property investors.

The development exemption

A development exemption is going to be introduced which will be available to any person who undertakes qualifying development work, even if they hold the property on capital account (it is assumed that property held on revenue account will generally be subject to the existing land laws).

As set out above, the new rules are not expected to apply to a property developer. However, if the developer holds and develops land that is not already captured by the existing land rules and the development work results in a new build on that land, then this new development exemption may apply to development work undertaken on that land.

The exemption may also apply to a property developer who holds some of their properties as an investment over the long term.

This exemption will apply to the property, not the taxpayer. So, if a property developer holds multiple parcels of land outside of the land rules, but only develops one parcel, they cannot use the exemption to claim interest deductions on the other parcels of land. The effect of the exemption is that the developer will be entitled to a deduction for interest paid on any additional debt acquired for the development activity only.

The Government also left open the possibility that some forms of remediation work may be included as development work to which the exemption would apply. Remediation work that is expected to qualify for the development exemption includes some types of work that extend the life of a building, such as earthquake strengthening and weatherproofing. The exemption would also be available for conversions of commercial or industrial properties to residential property.

Final thoughts

While the new rules are unlikely to apply directly to work undertaken as part of a property development business, it would be prudent for developers to watch for developments on these rules as the legislation is introduced and passed.

In particular, developers will likely be interested in the rules around the meaning of new build to ensure that they are not making their properties less attractive to prospective purchases looking for residential investment properties. The key issues that need clarification include:

- The final form of the 'new build' definition and whether there are any grey areas for certain developments (such as for remedial work)
- How long a developer can hold a property before it ceases to be a new build (ie, whether it has to change hands within 12 months of the code of compliance certificate being issued).

Inland Revenue also left open questions of whether certain types of property should be carved out of the rules, such as student accommodation, work accommodation, serviced apartments that were not readily substitutable for owner-occupation and dual purpose buildings on the same title. This means there is still a degree of uncertainty around the edge of the rules and what they will apply to, that developers or owners of these types of property will be keenly interested in.

Our tax team are happy to provide more information on how these rules may apply to your development, or to discuss how and whether the rules will apply to properties that you have recently developed for sale.

Auckland

188 Quay Street
Auckland 1010

PO Box 1433
Auckland 1140
New Zealand

P: +64 9 358 2555
F: +64 9 358 2055

Wellington

Aon Centre
1 Willis Street
Wellington 6011

PO Box 2694
Wellington 6140
New Zealand

P: +64 4 499 4242
F: +64 4 499 4141

Christchurch

83 Victoria Street
Christchurch 8013

PO Box 322
Christchurch 8140
New Zealand

P: +64 3 379 1747
F: +64 3 379 5659