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Email message

To:	Deputy Commissioner, Policy & Strategy Inland Revenue Department
Email:	Policy.webmaster@ird.govt.nz
From:	nsaTax Ltd
Date:	26 February 2019
Subject:	**RING-FENCING RESIDENTIAL RENTAL DEDUCTIONS**

To whom it may concern,

We set out below our submissions concerning ring-fencing of residential rental deductions as set out in the Taxation (Annual Rates for 2019–20, GST Offshore Supplier Registration, and Remedial Matters) Bill introduced on 5 December 2019.

The matters covered in this submission represent the major issues we perceive with the draft legislation. There are many other issues with the draft legislation, however, limited time and resources on our part do not allow all issues to be covered in this submission.

If you would like to discuss any of the points raised, please contact Philip Bell or MaryAnne Anderson in the first instance.

Yours sincerely
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Ref: 115156_1-Ring-fencing rental losses - draft legislation.docx

SUBMISSIONS ON TERMINOLOGY

Submission: Terminology - Divestment v Disposal

The term "divestment" should be removed from the legislation and replaced with the term "disposal".

Explanation:

1. Sections DB 18AC and DB 18AD deal with the ring-fencing rules for a portfolio of residential rental properties ("RRPs"). Sections DB 18AG and DB 18AH deal with the ring-fencing rules for non-portfolio RRPs (property-by-property basis). In broad terms these sections are aimed at fundamentally the same thing albeit on a portfolio v non-portfolio basis.

2. Sections DB 18AC and DB 18AD use the term "divestment" in various headings. Sections DB 18AG and DB 18AH use the term "disposal" in various headings. The term divestment is not defined in the Income Tax Act 2007 ("the Act"), nor is it used in the Act at all. The term divestment has never been used in any of the predecessor Acts of 1954, 1976, 1994 or 2004 Act. The term "dispose", "disposal" and "disposition" are used extensively throughout the Act and there is case law which considers the term "disposal" and its derivatives.

3. Introduction of a new undefined term is inconsistent with the Act and case law, and creates confusion.

Submission: Terminology – Tainted and Untainted

The terms "tainted" and "untainted" should be removed from the legislation

Explanation:

1. Sections DB 18AC to DB 18AK make various references to the terms "tainted" and "untainted". These are not defined terms in the Act.

2. These terms are commonly understood by tax advisors, taxpayers and IRD to mean land which when sold will be subject to tax due to the taxpayer being associated with a dealer, developer or builder (association gives rise to "tainting").

3. The use of these terms within the proposed legislation creates confusion because the context in which they are used is entirely unrelated to common usage.

4. The terms are meaningless and superfluous.

5. If they are not removed, they should at least be defined.

Submission: Terminology - Long, Confusing and Repetitive Terminology

Long winded and repetitive terminology should be defined within the legislation.

Explanation:

1. The term "land that was residential rental property at some time when they owned the land" is repeated 13 times within sections DB 18AC and DB 18AD.

2. The legislation refers multiple times to "residential rental property" and "land that was residential rental property at some time when they owned the land". This phrase could be referred to once as "residential rental property and land that was residential rental property at some time when they owned the land (the **RRP Land**)" and thereafter referred to as the "RRP Land". This would make the legislation far easier to read and understand.

Submission: Terminology - The terms "piece of property" and "new piece of property" are clumsy and confusing.

The terms "piece of property" and "new piece of property" are clumsy and confusing. A better term would be "non-portfolio property" and "new non-portfolio property" which clearly distinguishes these from portfolio property.

SUBMISSIONS ON INTEREST EXPENDITURE RULES

Submission: Interest deductibility rules for interests in a trust

Section DB 18AJ is ineffective and unworkable.

Explanation:

1. Section DB 18AJ attempts to ring-fence interest deductions in relation to funds borrowed to acquire an interest in a company or trust.

2. It is not possible to acquire an interest in a trust. A trust is not an "entity" in which a person can hold or acquire an interest. It is a relationship between the settlors, trustees, beneficiaries.

3. The suggested definition of a person's interest in a trust is likewise fundamentally flawed.

Submission: Applied capital percentage

The rules will result in absurd out comes.

Explanation:

1. Example: a LTC owns a residential property which cost $600,000 and which is used as the private residence for the individual shareholders. The purchase was funded $600,000 through share capital of the LTC with the share capital funded from cash held by shareholders. The shareholders have also borrowed $400,000 and applied these funds to subscribe for further share capital in the LTC which in turn is used to acquire a RRP.

2. Under the proposed legislation, the applied capital percentage is 40% as $400,000 out a total share capital of $1,000,000 has been used to acquire the RRP.

3. Accordingly, only 40% of the interest incurred by shareholders are treated as deductions relating to RRP and subject to the ring-fencing rules even though effectively 100% of the borrowed funds were indirectly applied to acquire a RRP i.e. the $400,000 was borrowed by shareholders and applied as share capital to acquire the RRP.

4. The remaining 60% of interest deductions are not subject to the ring-fencing rules and presumably would be fully deductible.

5. This is an absurd outcome as clearly the $400,000 borrowed funds were used to acquire the RRP.

Submission: Residential land-rich entities

The rules do not cater for subsequent transactions by a residential land-rich entity.

Explanation:

1. Subsequent actions by a residential land-rich entity may result in ring-fenced RRP deductions even though no RRP is owned.

2. For example, a LTC owns a residential property which cost $600,000 and which is used as the private residence for the individual shareholders. The purchase was funded $600,000 through share capital of the LTC with the share capital funded by cash held by shareholders i.e. there are no borrowings in relation to this share capital. The shareholders borrow $400,000 and subscribe for further share capital in the LTC which is used to acquire a RRP for $400,000.

3. Three years later, the LTC sells the RRP for $400,000, and applies the sale proceeds to acquire a managed share portfolio.

4. Following sale of the RRP, the LTC remains a residential land-rich entity as the private residential property constitutes greater than 50% of the LTC's assets. The applied capital percentage remains at 40% (total share capital is $1,000,000 with $400,000 of this applied to acquire the RRP).

5. Interest incurred by the shareholders will be ring-fenced to the extent of 40% even though the LTC no longer holds a RRP. No deduction is claimable by the shareholders as they have no RRP income attributed to them by the LTC.

6. This is an absurd outcome.

Submission: Valuation of assets for interest limitation rules

1. The definition of a "residential land-rich entity" is confusing at is applies to trusts.

2. The definition refers to a trust "with" RRP as trust property. This term should be defined in the same way as it is for other entities. The trustees of a trust own property in the same way that any other person owns property.

3. It is unclear what is meant by a trust "with" RRP. It presumably means something different than ownership otherwise the word "own" would have been used. If it is intended to reflect a trust that has the use of RRP but does not own it, the definition should specify this. If this is the case, then presumably it is possible for a company, partnership or LTC to have use of a RRP without ownership in the same way. If so, the definition relating to these entities should

likewise use the term “with” and the legislation should specify what is meant by “with” as opposed to “own”.

Submission: Applied Capital Percentage

The legislation should specify a measurement date for the "applied capital percentage" in sections DB 18AK and DB 18AJ.

The applied capital percentage should cater for changes in capital structure during the course of an income year.

The applied capital percentage does not work and will result in absurd outcomes.

Explanation:

1. The definition of "applied capital percentage" in sections DB 18AJ & DB 18AK require measurement of the relevant entity's capital used to acquire RRP. However, there is no indication when that measurement is undertaken e.g. at the start of the year, end of the year, or some other time.

2. The rules should cater for changes in the applied capital percentage throughout the year. For example, at the start of the income year a shareholder had borrowed $600,000 and had subscribed for 100% of the share capital in a company. The company had used all of those funds to acquire a RRP. The company has a March balance date.

3. On 31 March, the shareholder borrows a further $400,000 and subscribes for additional shares in the same company. The company applies the $400,000 to buy a share portfolio.

4. The applied capital percentage measured at the start of the income year is 100%. The applied capital percentage at the end of the income year is 60%. The weighted average applied capital percentage calculated on a daily basis is 99.9%. The legislation does not indicate when the applied capital percentage is measured so it could be any three of these figures.

Submission: Specific tracing rules

Paragraph 5.1.45 of the RIS states that "… interest allocation rules would add substantial complexity, and increase compliance and administrative costs. Because money is fungible, it is very difficult to attempt to match borrowings to particular investments (tracing)."

It goes on to state at paragraph 5.1.48 that "… Given the substantial complexity that interest allocation rules would introduce, we recommend against such rules."

Despite those observations, the rules dealing with interest deductibility require a specific tracing of the use of funds e.g. section DB 18AJ(4) definition of applied capital percentage states "… the percentage of the residential land-rich entity's

capital that the residential land-rich entity has used to acquire residential rental property."

This rule suffers from all of the issues noted in the RIS regarding fungibility of money and as a result will be ineffective and open to manipulation. Refer to our previous submissions on timing of measurement, changes to capital structure during the year and changes to underlying investments during the income year.

SUBMISSIONS ON TRANSFERRING RING-FENCED DEDUCTIONS

Submission: Transfer of ring-fenced deductions by company

A mechanism similar to making a subvention payment should be developed for transferring ring-fenced deductions from company to company.

The transfer of ring-fenced deductions should not be limited to wholly owned group companies.

Explanation:

1. Section DB 18AI allows a wholly owned group of companies to transfer ring-fenced deductions. The mechanism for transferring losses is akin to a loss offset under subpart IC of the Act. The transfer or offset of ring-fenced deductions will create unimputed retained earnings for the recipient company which in turn creates an uncrystallised tax liability on the ultimate distribution of retained earnings.

2. To avoid creating unimputed retained earnings, a mechanism to allow subvention of the ring-fenced deductions should be developed. This could easily be achieved by reference to the existing rules in subpart IC.

3. The transfer of ring-fenced deductions should not be limited to wholly owned companies. The Act allows all other losses to be transferred by way of loss offset or subvention by ordinary group companies (66% common ownership). There is no mischief in allowing ring-fenced deductions to be transferred between ordinary group companies.

Submission: Transfer of ring-fenced deductions for consolidated groups and amalgamated companies

Rules should be developed to deal with the treatment of ring-fenced deductions for consolidated group companies and amalgamated companies.

The proposed rules do not deal with ring-fenced deductions in consolidated group companies or amalgamated companies which is inconsistent with the rest of the Act.

Submission: Transfer of ring-fenced deductions

The draft legislation should specify the order in which ring-fenced deductions are utilised e.g. a first in first out ("FIFO") basis.

Explanation:

1. A FIFO basis is implied for current year, prior year and transferred ring-fenced deductions for a wholly owned group company by virtue of the reference to continuity for companies and sections IA 5 and IP 3.

2. However, there is no indication as to the order of current year, prior year and transferred ring-fenced deductions are utilised for individuals, LTC's, partnerships or trusts. This is directly relevant for the purposes of sections DB 18AD and DB 18AH.

SUBMISSIONS: OTHER MATTERS

Submission: Notification requirements for Dealers, Developers, Builders, and those acquiring land for the purpose or intention of disposal.

The notification requirements in section DB 18AF for dealers, developers, builders and those acquiring land for the purpose or intention of disposal should be removed.

Explanation:

1. The effect of the definition of "residential rental property" and the exclusion in section DB 18AF is that every taxpayer who is in the business of dealing in land, developing land, erecting buildings, or who has acquired land for the purpose or intention of disposal, will be obliged to separately disclose each revenue account property to the Commissioner and track separately income and expenses relating to that income.

2. It is nonsensical to provide a carve out from the ring-fencing rules for these taxpayers, yet at the same time impose onerous reporting requirements under the same rules. Taxpayers with multiple development properties would not typically record holdings costs separately for each development property. These rules impose additional requirements on such taxpayers even though they are not caught by the ring-fencing rules.

3. These entities will already be identified by IRD as dealers, developers or builders by virtue of their industry activity, and will most likely be GST registered in relation to such properties. Any further notification is unnecessary. This obligation will increase compliance costs significantly even though such land is outside the proposed rules.

Submission: De minimis rule

A de minimis threshold should be introduced.

Explanation:

1. The proposed rules are complex, confusing and onerous and will impose significant compliance costs on many taxpayers who are substantially unaffected by these rules. In additional, unsophisticated taxpayers who prepare their own tax returns will not understand the rules resulting in significant non-compliance.

2. We recommend a de minimis rule be introduced to remove the obligation to comply with these rules. If such a de minimis threshold was set at $5,000 (a maximum $1,650 tax benefit based on the top marginal tax rate), that would remove a large portion of investors from complying with these rules.

3. These rules are unlikely to achieve the policy objectives for taxpayers with such a low annual tax benefit. For the majority of investors, a RRP will be a second property (the first being a private residence). A maximum tax benefit of $1,650 per annum or $4.50 per day, will not alter the behaviour of these taxpayers, will have no impact on the housing market, will create significant additional compliance costs and will result in significant non-compliance.

4. These rules should be targeted at "property speculators" who highly gear their rental properties creating significant tax losses in favour of tax free capital gains.

Submission: Land which is part residential and part commercial

The proposed legislation does not deal with land which is used for both residential and commercial purposes.

A mechanism should be developed to specify how the two components should be measured bearing in mind that the capital value or annual value set by the relevant local authority will not distinguish between the two components.

An apportionment based on area is not likely to be relevant due to the different value/cost of fit out and chattels e.g. a residential apartment is likely to have a greater value than a relatively bare retail space.

Submission: Use of ring-fenced deductions against other land related income

Paragraph 5.1.12 of the Regulatory Impact Assessment ("RIS") states that "… rental losses are able to be used against taxable land sales to the extent they reduce the taxable gain to nil,…". This policy objective is not met by the proposed legislation.

Explanation:

1. The draft legislation only allows RRP deductions to be offset against RRP income. The legislation does not allow RRP deductions to be offset against income from, for example, land acquired for the purpose or intention of disposal or a land development business.

2. For example, section DB 18AC(2) only applies to assessable income derived from RRP i.e. "residential rental property income" and "net disposal income". Development land or land acquired for the purpose or intention of resale is not RRP land due to its specific exclusion and therefore income derived from such revenue account land cannot be offset against ring-fenced deductions despite this being the clear policy intent.

Submission: Leased land

The rules should apply to RRP either owned or leased by an entity. The rules only apply to RRP owned by an entity.

Submission: Depreciation loss and depreciation recovery income.

The proposed rules may result in a taxpayer being taxed on depreciation recovered despite the underlying depreciation deductions being denied.

Explanation:

1. The proposed rules will result in ring-fenced deductions and such deductions will be a composite of various expenses including deprecation loss.

2. When a RRP is sold, it is conceivable that depreciation recovery income will arise on RRP related property (for example, chattels, historical depreciation on buildings). The legislation does not allow for depreciation recovery income to be offset against current year or carried forward ring-fenced deductions. Such depreciation recovery income arises under subpart EE of the Act and is therefore neither "residential rental property income" or "net disposal income". Depreciation recovery income arises from the disposal of chattels which are not RRP themselves, and it arises under subpart EE of the Act and not sections CC 1 to CC 2.

3. The outcome is that depreciation recovery income will be subject to tax even though the underlying depreciation deductions have been denied under these rules. That is a "double hit" for the relevant taxpayer.

4. Ring-fenced deductions should be claimable against such depreciation recovery income from RRP related chattels.

Submission: Financial arrangement income

Ring-fenced deductions should be claimable against financial arrangement income arising from debt related to the RRP.

Explanation:

1. The proposed rules will apply to both New Zealand and offshore situated RRP. It is quite likely that offshore RRP will be funded at least in part by foreign denominated borrowings giving a natural hedge to foreign currency movements.

2. It is conceivable that when a RRP is sold and the related foreign currency debt is repaid, movements in the exchange rate may give rise to gains with any such gains automatically taxable under subpart EW of the Act.

3. The legislation does not allow for such financial arrangement income to be offset against current year or carried forward ring-fenced deductions. Such financial arrangement income arises under subpart EW of the Act and does not represent "residential rental property income" or "net disposal income" as is required by the rules.

4. The outcome is that financial arrangement income will be subject to tax even though the underlying interest deductions and foreign currency losses to which they may relate have been denied as deductions under these rules. That is a "double hit" for the relevant taxpayer.

5. The same issue can arise in relation to foreign denominated debt used to acquire shares in the relevant entity and used to acquire RRP.

6. Ring-fenced deductions should be claimable against such financial arrangement income.

Submission: Different classes of shares

The interest limitation rules in section DB 18AJ should cater for situations where there are different classes of shares.

Explanation:

1. The interest limitation rules for a company in section DB 18AJ focus on a "person's interest" (section DB 18AJ(5)). A "person's interest" in a company is defined with reference to their voting interests.

2. It is common place for companies to have on issue more than one class of share and typically only one class of share will carry voting rights. The focus on voting rights will restrict the ability of some taxpayer's to utilise their interest deductions.

Example:

A company has two shareholders; X and Y. The company has issued 100 'A' shares and 1,000,000 'B' shares. The 'A' shares carry voting rights but no entitlement to distributions. The 'B' shares carry no voting rights but participate in distributions.

X holds all of the 'A' shares in the company plus 60% of the 'B' shares. Y owns 40% of the 'B' shares in the company.

In relation to the 'A' shares, X contributed $200 to acquire the 100 'A' shares and the $200 was used to meet company establishment costs. X subscribed $600,000 for 600,000 'B' shares from surplus cash i.e. no borrowings. Y subscribed $400,000 for 400,000 'B' shares and funded this by way of $200,000 cash and $200,000 borrowings. The borrowings attract a fixed rate of interest of 4.5%.

The $1m of subscribed capital for the 'B' shares were used to acquire a RRP. The company owns no other assets and is therefore a "residential land-rich entity" as defined.

The taxable income derived by the company in relation to the RRP after deducting all allowable expenses is $25,000. The RRP runs at a profit because there are no interest deductions in the company.

Shareholder Y is economically entitled to 40% of the company's profits being $10,000. The only borrowings in relation to capital used to acquire the RRP is on shareholder Y's borrowings and incurs interest of $9,000.

Shareholder Y should be entitled to claim their interest expense of $9,000 against their share of the residential rental property profit. Under the rules as drafted, they are not entitled to.

Submission: Portfolio and property-by-property calculations

The draft legislation appears to allow shareholders in an LTC or partners in a partnership to take different positons in relation to an RRP. For example, an LTC has two shareholders and two RRP's. The legislation allows shareholder 1 to elect to treat RRPs on a portfolio basis and shareholder 2 to elect to treat the RRP's on a property-by-property basis.

It is not clear whether this is an intended outcome.