

# The Treasury

## Budget 2018 Information Release

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**Tax policy report: Ring-fencing rental losses: Cabinet paper seeking agreement to key design features and release of officials' issues paper**

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<b>Date:</b>	1 March 2018	<b>Priority:</b>	<b>High</b>
<b>Security level:</b>	In Confidence	<b>Report no:</b>	T2018/482 IR2018/121

**Action sought**

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	<b>Action sought</b>	<b>Deadline</b>
Minister of Finance	<b>Agree to sign and refer</b> the attached Cabinet paper and draft issues paper to the Cabinet Office for consideration at the DEV meeting on 21 March 2018.	10am Thursday 15 March
Minister of Revenue	<b>Agree to the recommendations and sign and refer</b> the attached Cabinet paper and draft issues paper to the Cabinet Office for consideration at the DEV meeting on 21 March 2018.	10am Thursday 15 March

**Contact for telephone discussion (if required)**

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<b>Name</b>	<b>Position</b>		<b>Telephone</b>	
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1 March 2018

Minister of Finance  
Minister of Revenue

## **Ring-fencing rental losses: Cabinet paper seeking agreement to key design features and release of officials' issues paper**

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### **Executive summary**

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1. The Government has committed to a number of policy measures aimed at making the tax system fairer and improving housing affordability for owner-occupiers by reducing demand from speculators. One of these measures is to introduce loss ring-fencing on residential investment property, so that investors will no longer be able to offset tax losses from their residential investment properties against their other income (eg, salary or wages, or business income), to reduce their tax liability.
2. The attached Cabinet paper seeks Cabinet agreement to key design features for the proposed ring-fencing rules, and approval to release the officials' issues paper for public consultation in the week of 26 March 2018.
3. Consultation would be for a period of six weeks from the date the issues paper is released. After submissions received at consultation have been considered, Cabinet's agreement to the final design of the rules will be sought.
4. Agreement by Cabinet to the recommendations of the attached Cabinet paper would mean that the revenue from this proposal can be offset against the Budget 2018 allowances. The proposal is estimated to increase tax revenue by \$325 million over the forecast period. This assumes a three-year phase in – the most conservative fiscal option. An additional \$245 million in revenue could be realised if an accelerated introduction is opted for following public consultation.

## **Recommended action**

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We recommend that you:

- (a) **Agree to sign and refer** the attached Cabinet paper and draft issues paper to the Cabinet Office by 10am Thursday 15 March for consideration by the Economic Development Committee at its meeting on 21 March.

Agreed/Not agreed

Agreed/Not agreed

- (b) **Note** that the attached draft officials' issues paper is subject to minor editorial and technical changes.

Noted

Noted

- (c) **Note** that should Cabinet agree to recommendations in the attached Cabinet paper, the revenue from this proposal will be offset against the Budget 2018 allowances.

Noted

Noted

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Policy Manager  
Policy and Strategy  
Inland Revenue

**Hon Grant Robertson**  
Minister of Finance  
/ /2018

**Hon Stuart Nash**  
Minister of Revenue  
/ /2018

## Background

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5. Officials have previously provided you with advice on rental loss ring-fencing, and key design issues to be decided on [T2017/2637, IR2017/615 and T2017/2962, IR2017/674 refer].

6. Officials have progressed design proposals for the proposed rental loss ring-fencing rules, and have prepared a draft officials' issues paper setting out the proposals, and seeking submissions on aspects of the detail of the design.

7. The attached Cabinet paper seeks Cabinet agreement to key design features for the proposed ring-fencing rules, and approval to release the officials' issues paper for public consultation in the week of 26 March 2018.

## Proposed key design features

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8. The proposed key design features for the ring-fencing rules, which the attached Cabinet paper seeks Cabinet's agreement to, are set out below.

### Property the rules would apply to

9. It is proposed that the loss ring-fencing rules would apply to "residential land". We think the rules should use the definition of "residential land" that already exists for the bright-line test, which currently taxes sales of residential land bought and sold within two years.<sup>1</sup>

10. It is proposed that the rules would **not** apply to:

- a person's main home;
- a property that is subject to the mixed-use assets rules (eg, a bach that is sometimes used privately and sometimes rented out); or
- land that is on revenue account because it is owned by someone in a land-related business (ie, a business of land dealing, development of land, division of land, or building).

### *Main home and trust ownership*

11. Because a significant number of family homes in New Zealand are owned by family trusts, the definition of "main home" would ensure that a home owned by a trust can be regarded as a main home. As is the case for the bright-line rules, we suggest that a dwelling

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<sup>1</sup> It is proposed that the bright-line period be extended to five years (see [Supplementary Order Paper No 13](#) to the Taxation (Annual Rates for 2017-18, Employment and Investment Income, and Remedial Matters) Bill).

owned by a trust only be considered a main home (so not subject to the loss ring-fencing rules) if it is the main home for a beneficiary of the trust, provided that a principal settlor of the trust does not have a different main home. This restriction would ensure that trust ownership cannot be used to claim multiple properties as main homes, and so not subject to the loss ring-fencing rules.

### ***Mixed-use assets not subject to the rules***

12. The mixed-use asset rules in the Income Tax Act 2007 may apply to houses that are sometimes used privately and sometimes rented out. The mixed-use asset rules provide for the apportionment of expenditure, so that only expenditure that relates to days the asset is actually used to earn income is deductible.<sup>2</sup> The mixed-use asset rules quarantine (or ring-fence) losses where there is low income-earning use of the asset. Those quarantine rules would cover most if not all mixed-use asset losses. As such, we suggest that property subject to the mixed-use asset rules should be scoped out of the loss ring-fencing rules.

### ***Land held on revenue account because of a land-related business***

13. Taxpayers in certain business relating to land hold their land on revenue account, so the profits on sale will be taxed. This applies to people in the business of dealing in land, developing land, dividing land into lots, or erecting buildings.

14. At balance date, such taxpayers are likely to have a number of properties on hand, which may not be currently rented out, and there could be losses in respect of those properties. Those losses are likely to be exceeded by income from other sales or rental activity in the year, with the taxpayer being in an overall profit position.

15. However, in any overall loss-making year, we do not think the loss ring-fencing rules should apply to these taxpayers. Fundamentally, there is not the same concern in relation to these taxpayers about any of their deductible expenses relating to untaxed gains, as all of their land is on revenue account, and therefore in the tax base. Further, it would not be desirable to ring-fence losses for these taxpayers, as that could discourage new developments, which would be a barrier to increasing supply of housing.

16. Therefore, we propose that the ring-fencing rules not apply to taxpayers who hold land on revenue account because they are in a land-related business, and their land is in the tax base. This would enable those taxpayers to use losses arising in any year against other income – for example within their corporate group (as they are likely to be companies).

### **Portfolio basis**

17. We propose that the loss ring-fencing rules should apply on a portfolio basis. That would mean that investors would be able to offset losses from one rental property against

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<sup>2</sup> Previously, days when the asset was unused but was available for income-earning use also gave rise to deductions.

rental income from other properties – calculating their overall profit or loss across their portfolio.

18. The alternative – a property by property basis – would mean that each property would need to be looked at separately, with losses on one not able to be offset against income from another.

19. A property by property approach would be stricter than a portfolio approach, achieving the highest level of ring-fencing. However, it would add complexity, as losses would need to be tracked separately for each property. Moreover, a property by property approach may just result in taxpayers with portfolios re-balancing their debt funding to avoid having loss-making properties (or at least minimising the extent to which any particular property is loss-making). That taxpayer response would be inefficient, and may mean that a property by property approach may have no real advantage over a portfolio approach – adding considerable complexity and increasing compliance costs for no real gain.

20. Also, a property by property approach may be seen as unfair in that if a taxpayer has two properties and breaks even on the portfolio overall, the taxpayer's tax position will depend on whether they break even on both properties or make a gain on one and a loss on the other.

21. We therefore propose that the ring-fencing rules apply on a portfolio basis, so a person with multiple properties would calculate their overall profit or loss across their whole residential portfolio.

### **Use of ring-fenced losses**

22. We propose that ring-fenced residential rental or other losses from one year be able to be offset against:

- residential rental income from future years (from any property):
- taxable gains on the sale of any residential land.

### ***Non-taxable sale***

23. Most residential rental investors would not be subject to tax on the sale of their investment properties under current tax rules. If losses could be realised when a rental property is sold, whether or not the sale is taxed, this may encourage investors to sell sooner, increasing the supply of housing for owner-occupiers, especially in the short term. However, releasing losses on a non-taxable sale would reduce the effectiveness of the measure. It would also provide scope for investors with losses to hold properties for just over the bright-line period, sell to access losses, and then buy another rental and repeat this.

## ***Taxable sale***

24. However, in some circumstances, the sale of a residential rental property may be taxed under one of the land sale rules in the Income Tax Act – or the taxpayer may have taxable gains on the sale of other residential property.

25. We propose that where a taxpayer sells a property that is subject to the ring-fencing rules and the sale is taxed, any ring-fenced residential rental or other losses the taxpayer has could be used to reduce the taxable gain on sale to nil. Any remaining unused losses would stay ring-fenced, and could be used against any future residential rental income or taxable gains on other residential land sales.

26. In the case of a property with ring-fenced losses that is taxed under one of the land sale rules on disposal, there is an argument that the losses should be able to fully utilised (ie, unfenced) at that point, and be used to offset any other income of the taxpayer. This would reflect that all of the economic income from the investment has been taxed (the rental stream and the capital gain), and that the investor should not be penalised for making an overall loss on the investment.

27. However, if the rules apply on a portfolio basis, as proposed, allowing accumulated losses to give rise to a tax loss on if the disposal is subject to one of the land sale rules would create risks. For example, it would enable a portfolio investor to sell a property that has made a small capital gain within the bright-line period and access what might be substantial portfolio-wide accumulated ring-fenced losses, which could then be offset against other income.<sup>3</sup> This would significantly undermine the credibility of the rules.

28. We therefore propose that where a disposal is caught by one of the land sale rules, ring-fenced residential rental losses should be allowed to be used only to the extent they reduce the taxable gain to nil, with any further unused losses remaining ring-fenced.

## **Specific rules to prevent structuring around the ring-fencing rules**

### ***Interposed entities***

29. We propose specific rules to ensure that a trust, company, partnership or look-through company cannot be used to get around the ring-fencing rules.

30. Without rules to address this, a simple way to get around the ring-fencing rules would be for a taxpayer to interpose one of these entities<sup>4</sup> to hold a residential rental property, and borrow money to acquire an interest in the entity. For example, a taxpayer could borrow money to buy shares in a company, which uses those funds to buy a residential investment property. Because the money is borrowed to buy shares, the individual taxpayer would be

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<sup>3</sup> While there are ring-fencing rules in relation to the bright-line test, they only apply to deductions for the cost of the land, not other costs.

<sup>4</sup> These ownership structures are referred to here as entities for simplicity.

able to claim deductions for the interest on the borrowings, and offset those amounts against other income sources.

31. The issues paper suggests how specific rules to deal with interposed entities could operate. The suggested approach is to define when such entities will be “residential property land-rich”. It is proposed that this would be the case where over 50% of the entity’s assets are residential properties within the scope of the ring-fencing rules, and/or shares or interests in other residential property land-rich entities. The rules could then provide that deductions for interest on money borrowed to acquire an interest in the entity (eg, shares, securities, a partnership interest, or an interest in the trust estate) would be allowed only to the extent they do not exceed distributions the taxpayer received from the entity. Any excess of interest over distributions would be ring-fenced.

### ***Interest allocation***

32. We have considered whether specific interest allocation rules are required, as without them investors may be able to structure around the loss ring-fencing rules. For example, this could be done by reorganising funding so that business assets other than rental properties are debt-funded, and rental properties are equity-funded to the greatest extent possible.

33. However, interest allocation rules would add substantial complexity and compliance costs. Because money is fungible, it is very difficult to attempt to match borrowings to particular investments. Rules that allocate debt firstly to ring-fenced investments may be seen as unfair. And a pro rata allocation of interest between assets that are subject to the ring-fencing rules and those that are not would require regular valuation of assets.

34. Another option would be for the rules to allocate all of the interest on a loan that was secured by a residential property to the property. However, this would create issues for many people who use their rental properties to secure loans for their businesses. This would impact on small and medium business’ access to capital. In addition, many arrangements could be even more difficult to apply interest allocation rules to, as revolving credit facilities are often used to fund both a rental property and a business.

35. We do not propose specific interest allocation rules because of the considerable complexity and compliance costs they would add, which would be particularly onerous on smaller taxpayers.

### **Timing of introduction of the rules**

36. It is proposed that the loss ring-fencing rules apply from the 2019-20 income year.

37. The Labour Party’s Fiscal Plan for 2018/19 indicated that the proposed loss ring-fencing rules would apply from the 2018-19 income year. But we think it is preferable for the rules to apply from 2019-20, so that there is at least legislation introduced before the start of

the income year<sup>5</sup> the rules will apply from – giving taxpayers a degree of certainty about how the rules will operate.

38. The rules could either apply in full from the outset, or alternatively they could be phased in. The Labour Party have publically indicated that the ring-fencing rules would be phased in over five years, with loss deductibility reducing by 20 percent per year. This would allow affected investors more time to adjust to the new rules, or to rearrange their affairs before the rules apply in full. However, with application pushed back a year from what has been indicated, arguably there is no need to phase the rules in. Or if the rules are phased in, this could be done over two or three years and Labour’s Fiscal Plan budget for this measure would still be met across the forecast period (to 2022).

39. Tax law changes are not usually phased in, and a phased introduction of the rules would result in some additional complexity. As such, the issues paper is asking for feedback on what approach is preferred.

**Financial implications**

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40. Agreement by Cabinet to the recommendations of the attached Cabinet paper would mean that the revenue from this proposal can be offset against the Budget 2018 allowances.

41. The amount of expected fiscal gain depends on whether the rules apply in full from 2019-20 or are phased in over two or three years. Inland Revenue estimates that three-year phase in would increase revenue by \$325m over the forecast period, and two-year phase in would increase revenue by \$480m. Full implementation from 2019-20 would increase revenue by an estimated \$570m.

42. The table below shows the current estimate of revenue impacts, assuming a three-year phase in:

	\$ million – increase/(decrease)				
<b>Vote Revenue Minister of Revenue</b>	2017/18	2018/19	2019/20	2020/21	2021/22 & outyears
Tax Revenue: Loss ring-fencing	-	-	10,000	125,000	190,000
<b>Total Revenue effect</b>	-	-	10,000	125,000	190,000

43. The three-year phase is the proposed base case as it is the most conservative fiscal option presented in the issues paper. Additional revenue from opting for a shorter phase in

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<sup>5</sup> For standard balance date taxpayers.

period, or full implementation from 2019-20, is expected to be included as a fiscal risk in Budget 2018.

## **Next steps**

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44. For the attached paper to be considered by the Cabinet Economic Development Committee at its meeting on Wednesday, 21 March 2018, it needs to be lodged with the Cabinet Office by 10 am, Thursday, 15 March 2018.

45. The attached Cabinet paper seeks Cabinet approval to release the officials' issues paper for public consultation in the week of 26 March 2018. Consultation would be for a period of six weeks from the date the issues paper is released.

46. In consultation with your offices, officials may make minor editorial and technical changes to the issues paper before public release.

47. A Regulatory Impact Assessment is being prepared, and will be finalised and follow shortly.

