The Treasury

Tax, Housing and RBNZ Information Release

April 2021

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Cabinet Document Details

Title:	**Cabinet Paper: CAB-21-SUB-0045: Backing first home buyers and encouraging property investment into new housing supply**
Date:	**8 March 2021**
Creator:	Minister of Finance, Minister of Housing and Minister of Revenue

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Minister of Finance

Minister of Housing

Minister of Revenue

Chair, Cabinet Business Committee

Backing first home buyers and encouraging property investment into new housing supply

Proposal

1 This paper contains measures to support first home buyers by reducing investor demand for existing housing and moderating house price growth. At the same time, the measures will incentivise investment in the new build market to increase housing supply. These measures form a package, alongside the measures to increase housing supply developed by the Minister of Housing, which are also before Cabinet ("Increasing housing supply and improving affordability for first home buyers and renters"), together with extensive urban development reforms underway and moves to ensure the Reserve Bank takes into account house prices through their monetary and financial policy mandates (CAB-21-SUB-0018 refers).

2 This paper seeks agreement on two reforms of existing measures that would decrease the tax advantages that are available to residential property investors (the measures), particularly with regard to the existing housing stock. The measures are:

2.1 extending the length of the bright-line test for residential property from its current five-year period; and

2.2 an in-principle decision to limit the interest deductions available for income earned from residential property investments.

3 This paper also seeks agreement on changes to First Home Products (First Home Grants and First Home Loans) and tenancy rights. The measures are:

3.1 increasing the income cap for First Home Products to $95,000 for a single buyer and to $150,000 for two or more buyers; and

3.2 increasing the house price caps for First Home Products for both existing and new properties (as shown in paragraph 79).

4 This paper also seeks agreement to consult with the public on a proposal to limit rent increases to once per year per property, instead of once per year per tenancy.

Executive Summary

5 Access to affordable housing is one of New Zealand's most persistent long-term challenges. The OECD's Better Life Index 2020 suggests New Zealanders spend the largest proportion of their disposable income on housing costs in the OECD. From 1991 to 2019 (before COVID-19), our house prices had the highest real growth in the OECD at 266%.

6 In mid-2020 as COVID-19 hit, economists, including those at the Treasury, Reserve Bank and all the retail banks, were forecasting house prices in New Zealand to fall by up to 10% over the next year. However, through 2020, the Real Estate Institute of New Zealand (REINZ) national median house price rose by 19% and economists are now forecasting further increases. There are a number of reasons for this. Demand for existing housing continues to increase, led by demand from multiple-property owners. For example, in December 2020, ANZ reported two record months of residential

property lending, of which 32% went to residential property investors and 18.3% to first home buyers. Reductions in interest rates, the easing of loan-to-value ratios by the Reserve Bank (which are now being reversed) and the continuation of New Zealand's historic undersupply of new housing compared to population growth are also driving market activity.

7 The Government's response to the housing crisis will be ongoing. There is no one silver bullet that will fix this long-running challenge. We intend to bring a rolling package of measures to Cabinet over the coming months to address housing affordability, support first home buyers and better incentivise investment in new supply. As noted on 15 February 2021 (CAB-21-MIN-0018 refers), Cabinet's policy objectives for the housing market are to:

   7.1 Ensure every New Zealander has a safe, warm, dry, and affordable home to call their own – whether they are renters or owners.

   7.2 Support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers.

   7.3 Create a housing and urban land market that credibly responds to population growth and changing housing preferences, that is competitive and affordable for renters and homeowners, and is well-planned and well-regulated.

8 The tax proposals in this paper contribute to the second objective by dampening investor demand for existing housing stock, thereby creating more opportunities for first home buyers. The proposed changes to First Home Products contribute to the first objective by providing financial support to more first home buyers.

9 Our proposal to extend the bright-line test for property acquired after the application date is expected to place downward pressure on house price growth by decreasing the tax advantage that property investors who make a profit on the sale of investment property have over some other forms of investment. The bright-line test currently makes gains on residential property beyond the main home taxable when the property is sold within five years. We suggest that Cabinet consider extending the test to either 10, 15 or 20 years. Decreasing the tax advantage that property investors can receive will reduce the amount investors are prepared to pay for a given house and the number of houses they will buy. The measure will support first home buyers and help to lift New Zealand's home ownership rates.

10 We also propose an in-principle decision to limit deductions for interest expenses on loans used to generate income from residential property. This measure is expected to reduce investor demand for residential property and put downward pressure on house prices, thereby creating more opportunities for first home buyers and supporting higher rates of home ownership. Key design decisions will be confirmed following public consultation. This measure will take longer to be put in place than the bright-line extension. We expect it to limit interest deductions from 1 October 2021.

11 Given the importance of increasing housing supply, we propose to exempt newly built homes from the bright-line extension (so that either the existing five-year test would continue to apply, or is dropped to zero years for newly built homes). We will also consider allowing investors that purchase new builds to continue to deduct interest expenses.

12 We also propose changes which will help prospective first home buyers (this includes second chancers) [1]. Our proposal to increase the income caps for First Home Products

[1] Second chancers are also eligible for the First Home Products. However, they must not have previously received the First Home Grant and must also not have realisable assets worth more than 20 percent of the house price cap for existing properties in the area they are buying. Currently second chancers make up 7% to 10% of all grants.

will expand the cohort of first home buyers that can access the First Home Grants and First Home Loans.

13 In many parts of the country the house price cap has begun to limit the number of houses first home buyers can buy using First Home Products. This is because lower quartile house prices in some places have increased above the current house price caps. Our proposal to increase the house price caps for First Home Products will address this. We propose increasing both existing and new property house price caps, lifting the price caps for existing houses by half the amount we propose for new builds.

14 We intend to direct Ministry of Housing and Urban Development officials to undertake consultation on a proposal to amend the Residential Tenancies Act 1986 (RTA) to limit rent increases to once every 12 months per property, instead of every 12 months per tenancy.

15 Consultation will help us understand the potential impacts and risks of the proposal, for example how many renters it would benefit, and potential landlord behaviour changes. Officials will report to the Ministers of Finance and Housing and the Associate Minister of Housing (Public Housing) on the outcome of consultation.

16 As well as progressing existing work to address supply side constraints, including through Resource Management Act and infrastructure funding reform, the Government is moving to address the short-term drivers of house prices. Accordingly, these measures have been developed at pace and several important design decisions remain to be made. We intend to announce these measures by mid-March and provide sufficient detail at that point to provide a level of certainty to investors about the direction these changes will take. We consider this approach necessary to allow for consultation with stakeholders and allow more time to get design decisions right for the measures.

17 The proposals in this paper form part of our package of housing measures. In addition to this paper, the following other matters will be progressed by the Government:

17.1 Measures in relation to the Reserve Bank to ensure that the Government's priorities around more affordable house prices and creating additional opportunities for first home buyers are taken into account when the Reserve Bank pursues its monetary policy and financial stability mandates (CAB-21-SUB-0018 refers).

17.2 The Minister of Finance and Minister of Housing are taking a package of measures designed to increase housing supply to Cabinet (see accompanying Cabinet paper "Increasing housing supply and improving affordability for first home buyers and renters").

17.3 The reform of the resource management regime, implementation of the National Policy Statement on Urban Development, and other work related to housing affordability, such as implementing transactions under the Infrastructure Funding and Financing Act 2020.

17.4 We will bring other measures to increase housing supply and support renters to Cabinet, as appropriate. There are other tangible actions that will be needed to reform the housing market, and we will consider how to take them forward as a cohesive package of reforms that shapes market expectations.

18 The housing market in New Zealand has generated poor outcomes for many New Zealanders over a long period of time; however, major reforms of the structural underpinnings of the housing system may result in near-term adverse consequences for some vulnerable groups. The likely impact on rents is complex and uncertain. Several factors explain increasing rents including the cost to purchase rentals. However, Treasury believe the strongest factor is renters' ability to pay. Following these reforms, the Ministry of Housing and Urban Development will monitor market

impacts closely, including on the rental market, to assess whether further interventions may be necessary.

19 [33]

The lack of affordable housing is one of the country's longest-standing and hardest issues

Access to affordable housing is a significant and growing concern for New Zealanders

20 New Zealand house prices are among the highest in the world relative to incomes. The OECD's Better Life Index 2020 suggests New Zealanders spend the largest proportion of their disposable income on housing costs in the OECD. From 1991 to 2019 (before COVID-19), our house prices had the highest real growth in the OECD at 266% and have increased markedly over the last year despite COVID-19. Problems are New Zealand-wide, rather than just in the major urban centres.

21 Home ownership rates are significantly lower now than they were at their peak. The proportion of people living in an owner-occupied home has dropped from 75.3% in 1991 to 64.3% in 2018. Home ownership rates have remained relatively stable over the last five years. However, rising house prices mean that many aspiring homeowners are struggling to raise a deposit to buy their first home. The decline in home ownership has occurred unevenly, with greater falls for Māori and Pacific peoples. For Māori, the proportion of people living in an owner-occupied home declined across most of the 20th and early 21st century. Since 1991 it fell from 57.4% to 47.2% by 2018. For Pacific peoples it has dropped from 50.8% in 1986 to 35.1% in 2018.

22 Home ownership has long-term impacts on equity and living standards; New Zealand homeowners are typically 14 times wealthier than non-homeowners. Furthermore, unaffordable housing disproportionately affects some population groups including Māori and Pacific peoples. High housing costs relative to income, poor housing quality and insecure tenure worsens child poverty, health outcomes and homelessness. Renters generally live in poorer quality housing that is more likely to be cold, damp, have mould and need major repairs, which leads to worse health outcomes for these households.

23 In addition to concerns about affordability, high house prices lead to higher private debt and can pose risks to macroeconomic and financial stability. Last year the Minister of Finance wrote to the Governor of the Reserve Bank to propose ways that the Government and the Reserve Bank could work together to address the issue of rising house prices as part of a wider suite of work that the Government is carrying out on housing market settings in the economy, both on the demand and supply sides of the housing market.

24 The Reserve Bank announced on 9 February that it has re-imposed LVR limits on both owner-occupiers and investors from 1 March (and further restrictions on investors from 1 May) due to increased financial stability concerns off the back of rising house prices during 2020.The Reserve Bank considers that a reasonable estimate of the impact of reinstating LVRs on house prices now would be a reduction in house price inflation of between 1 and 4 percentage points, against a counterfactual where LVR restrictions were not reinstated. This demonstrates that the tools available to the Reserve Bank are not able to address the broader issue of housing affordability, particularly given that the Reserve Bank's objectives relate to inflation, maximising sustainable employment and financial stability. The proposed measures will work in tandem with the Reserve Bank's macro-prudential tools, and ensure that monetary policy and fiscal policy are both contributing to improving the affordability of housing in New Zealand.

25 On 25 February the Minister of Finance announced changes to the Reserve Bank Remit, and issued a Section 68B notice under the Reserve Bank of New Zealand Act 1989 to require the Reserve Bank to consider the impact on housing when formulating

monetary and financial policy decisions. This included the direction that the Reserve Bank will have to take into account the Government's housing objective to support more sustainable house prices, including dampening investor demand for existing housing stock to help improve affordability for first-home buyers.

The causes of New Zealand's housing shortage are multi-faceted and complex

26 Housing unaffordability is caused by a number of supply and demand-side factors. It is a fundamental feature of housing markets that demand for property can increase substantially over a short period of time – for example as investor sentiment shifts – whereas the supply of housing is difficult to increase in the short-term. Because investor expectations of rising prices are a major determinant of demand for housing, increasing demand and rising prices can reinforce each other in the short run. Policy measures to increase supply also tend to have considerable lags. Consequently, it is important for demand-side measures to be implemented in the near-term in order to contain rising prices, and give the Government's package of supply-side measures time to take effect.

27 Supply constraints create uncompetitive urban land markets and contribute to rising house prices. Limited access to financial capital has constrained local councils' infrastructure investment and contributed to restricted growth. Restrictive regulations (such as zoning and height restrictions administered under the Resource Management Act 1991), a lack of long-term infrastructure planning, and increasing costs (such as building materials) have also contributed to constrained supply and high prices. As a result of these supply side factors, in the last 40 years New Zealand has not built enough houses; estimates of the shortage range between 40,000 and 130,000.

28 Demand-side factors are also putting upward pressure on prices. Falling interest rates have resulted in an increase in demand, which has driven house price increases for existing property owners while worsening the ability of first home buyers to enter the property market. The removal of LVR restrictions in April 2020 in response to COVID-19 allowed highly leveraged- investors to re-enter the market, exacerbating price pressures. High population growth has increased demand for housing over recent decades in New Zealand.

29 Investor presence in the housing market has increased substantially over the past year. In Q4 2020, on average, 40% of all property transfers were to multiple property owners – this is the highest level since Q2 2015. From June 2020 to November 2020 the total amount borrowed by investors for new residential lending increased by 116%, compared to just 63% for all other borrower types (excluding investors). In addition, the removal of the LVR restrictions increased the incidence of high leverage borrowing by investors (LVR over 70%), which increased by 314% from June to November 2020.

30 High demand and scarcity caused by regulatory and similar factors, and the resulting lack of competition between landowners, are driving higher land prices.

31 Finally, investors are active in the market partly due to the favourable tax treatment of housing investment over some other investments, such as term deposits. Existing tax settings exacerbate the issue of excess demand, leading to higher property prices than otherwise. Reform of existing tax measures is therefore an important part of our strategy to improve housing affordability and increase rates of home ownership.

32 Since 2017, the Labour Government has put considerable investment into addressing housing affordability in New Zealand. This includes the largest state-house build since the 1970s, establishing the National Policy Statement on Urban Development, record investments in infrastructure to support new housing, and changes to rental laws. Private building consents are now at their highest annual level since the early 1970s, while the December 2020 quarter saw a record quarterly level of dwelling consents. The long build-up of this crisis means it will take time to fix. The measures proposed in this paper are the next step, which work as a part of a package with the supply-side measures also before Cabinet, and Resource Management Act reform later this term. The Government cannot solve this long-standing issue alone, and this package is

designed to support local government and the private sector to supply infrastructure and build more affordable housing.

Our objectives for the housing market

33 The Labour Government has three overarching objectives as outlined in the Speech from the Throne: to keep New Zealanders safe from COVID-19; to accelerate our economic recovery, and; to lay the foundations for a better future. A focus on housing is a priority for this Government to lay those foundations for a better future, focusing on both the supply and demand sides of housing to see outcomes that are more productive and fair. The Government aims to improve access to the housing market for first home buyers and incentivise investment towards new housing supply.

34 Cabinet on 15 February 2021 received a companion paper ("Housing policy and the Reserve Bank") and in relation to that paper noted that the Government's objectives were as follows (CAB-21-MIN-0018 refers):

34.1 Ensure every New Zealander has a safe, warm, dry, and affordable home to call their own – whether they are renters or owners.

34.2 Support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers;

34.3 Create a housing and urban land market that credibly responds to population growth and changing housing preferences, that is competitive and affordable for renters and homeowners, and is well-planned and well-regulated.

35 We now seek Cabinet's formal agreement that these are the Government's policy objectives for the housing market.

36 The first objective is a general housing market outcome, supported by the third objective to address supply. The second relates to demand and aims to help rebalance the market in the meantime, support financial policy objectives to address abrupt house price changes, and give greater ability for prospective first home buyers to purchase while also seeking to allow private development, particularly in new housing supply.

37 The tax proposals in this paper are aimed at our second objective to support more affordable house prices through dampening investor demand and thereby supporting first home buyers. The proposed changes to first home products contribute to the first objective, by providing financial support for first home buyers. These measures will be complemented by other initiatives to further all three housing market objectives in a balanced way prior to the implementation of resource management reform. For instance:

37.1 The Minister of Finance announced measures to ensure that the Government's priorities around more affordable house prices and creating additional opportunities for first home buyers are taken into account when the Reserve Bank pursues its monetary policy and financial stability mandates (CAB-21-SUB-0018 refers). Further advice is being sought from the Reserve Bank on debt-to-income ratio limits – particularly on investors – and limiting interest-only mortgages.

37.2 The Minister of Finance and Minister of Housing are taking a package of measures designed to increase housing supply to Cabinet. (See accompanying Cabinet paper "Increasing housing supply and improving affordability for first home buyers and renters").

37.3 The Minister of Finance and Minister of Housing are also considering changes to the property price caps for First Home Products (First Home Grants and First Home Loans) and amendments to KiwiBuild property price caps.

38 To have a meaningful impact on housing supply and affordability, the proposed supply package is deliberately broad. In order to deliver more affordable homes, the Government will need to secure land, fund and finance infrastructure, and share some of the development and/or sales risk with the private sector. The nature of the package is also intended to send a clear signal to the market that the Government is serious about addressing the housing shortage and taking the heat out of asset prices, prompting a corresponding response from the market e.g. removing the incentives for landowners to hold onto their land in the expectation that it will increase in value in the future.

39 The proposed supply-side package is intended to have an initial impact in the next 12–18 months, particularly in terms of reducing expectations of significant future house prices gains. While it will not result in a significant number of houses built immediately, there will be visible progress along the way (e.g. land acquired and infrastructure completed). Over time, the options in the package will help to ensure an ongoing pipeline of housing supply, including affordable options, to meet a diverse range of needs and aspirations. The package will also complement the measures already underway to address supply, building on our Urban Growth Agenda and our record public infrastructure investments. The broader reform of resource management to enable housing supply is a key priority this term.

We propose to extend the bright-line test

40 Current tax settings mean the gains on the sale of most residential property are not taxed. This gives a tax advantage to property investors, encourages speculation, and incentivises investment in housing over other types of assets, such as savings accounts that earn interest. Moreover, as some groups have been locked out of home ownership, the non-taxation of these gains has led to an uneven form of wealth accumulation and may exacerbate wealth inequality.

41 The bright-line test was introduced by the previous National Government in 2015 to ensure the gains on the sale of residential investment property bought and sold within a specified time period were taxable – essentially ensuring the existing “intention test” could not be avoided where a sale was within two years.[2] The rule applies to rental properties and holiday homes but excludes the “main home”. Originally implemented with a two-year period in 2015, it was extended from 2018 to properties sold within five years.

42 However, most investor property sales are not captured by the current five-year test. CoreLogic data suggests that the median ownership period for property in New Zealand is typically seven to eight years, and Ministry of Housing and Urban Development analysis suggests that the number for property investors is roughly the same.

43 We propose to extend the bright-line test so that it captures a greater proportion of investor property sales. An extension of the bright-line test on investment property will support our goal of improving home ownership rates. A longer time period is designed to discourage speculative investment up front – essentially drawing a line in the sand for prospective property investors and reducing potential investor demand for existing housing stock. Decreasing property investors’ tax advantages will put downward pressure on house prices and benefit prospective first home buyers. The extension is likely to alter the distribution of property owners, with fewer investors purchasing over time, resulting in a greater proportion of owner-occupiers. This is consistent with our objective of supporting more sustainable house prices by reducing investor demand, and thereby supporting first home buyers.

44 We propose that Cabinet consider extending the bright-line test to either 10, 15 or 20 years. Factors relevant to the choice of duration are below:

2 The intention test essentially provides that if a property is acquired with a purpose or intention of sale, then the property will be taxable on sale.

44.1 A longer bright-line period (15 or 20 years) is likely to capture a larger number of sales and a greater amount of economic income, and therefore have more significant property market impacts and improve the fairness of the tax system more than a shorter period (either the current five year test or an extension to 10 years). CoreLogic data suggests that, in 2017, 90% of residential properties sold were held for 20 years or less (compared to around 40% held for five years or less). The longer the bright-line period, the more likely it is that owners will be unwilling or unable to wait out the full bright-line period. The Treasury favours a 20-year extension to the bright-line test.

44.2 A longer period (say, 20 years) is likely to mitigate the risk of lock-in for those who do not wish to hold for a lengthy period, as they will be less willing to wait out the longer length and will either choose not to enter the rental property market or sell within the bright-line period despite the tax liability. Given that approximately half of properties are sold within seven or eight years, a substantially longer test may mitigate lock-in risk in early years for a substantial number of properties.

44.3 It is important to note that there is already a lock-in effect under the existing five year bright-line test. A significant extension may cause an investor that would otherwise have held property for five years (to wait out the existing bright-line period) to sell earlier in time or not purchase a property in the first place. Moreover, a range of other factors including holding costs, interest rates (including our decision on interest deductibility) and anticipated house price growth will be likely to be impact investors' decisions on whether to wait out the bright-line period.

44.4 Finally, in many cases lock-in will not result in a property being under-utilised. That is, if a property owner delays selling a residential property, they are likely to either live in it or rent that property out. There will be some cases where lock-in does reduce the utilisation of housing however, such as for second homes close to city fringes that could be used as a main residence.

Table 1: Holding period for residential property sold in 2017

Holding period	**2 years or less**	**5 years or less**	**10 years or less**	**15 years or less**	**20 years or less**
Percentage of property sold	18%	42%	64%	83%	91%

Source*: CoreLogic data. Note: This data includes residential property sold by owner-occupiers as well as investors. The data excludes property which CoreLogic could not determine a holding period for (which may be a result of it being held for a very long period of time which could mean the results understate the average holding period). This data is for properties classified as either residential or lifestyle.*

45 In terms of its ambit and application date, we recommend that the extension of the bright-line test take effect for residential property, other than the main home. We are proposing that this would apply to property acquired shortly after the announcement date. Options for the precise application date are below from paragraph 93. Residential property acquired before the application date will either be outside the scope of the bright-line test or will continue to be subject to the existing bright-line period of five years depending on its purchase date. Other land sale rules (for example, those applying to speculators, land developers and dealers) will also continue to apply.

46 Changes to the existing tax system may run the risk of disrupting the existing pipeline of new housing and land development. To mitigate this risk, we propose that investment in new houses would be exempt from the extension and would, instead, either be subject to the five-year bright-line test or exempt entirely (see from paragraph 59 below).

We propose to limit the ability to claim tax deductions for interest expenses for income earned from residential property in calculating taxable income

47 Property investors can currently deduct the cost of mortgage interest from the gross income they earn from residential property for tax purposes. It means investors only pay tax on their net income; those with high expenses may make a net loss and therefore pay no tax on their rental income. In 2019, residential property investors claimed approximately $3.5 billion in deductions for interest expenses. This is expected to reduce this year due to lower interest rates. This advantages investment in property over other forms of investment because the current model of property investment – unlike typical personal investment – relies heavily on obtaining debt financing. It biases investment toward the property market, because the banking system makes it relatively easy to finance the purchase through borrowing secured against the property. The deductibility of interest payments also encourages further accumulation of debt within the household sector, as debt-financed purchasers are able to acquire more properties than equity-financed purchasers.

48 Around half of all lending to investors is interest-only. This would seem a clear enabler of speculative investment in the current tax-treatment regime, in particular with interest payments being deductible. The Minister of Finance has asked the Reserve Bank for further advice on limiting interest-only loans.

49 We propose that Cabinet agree in-principle to limit interest deductions for loans relating to residential property acquired on or after the application date. Cabinet is also asked to agree in-principle that the interest limitation rules will apply to loans drawn down after the application date, if they relate to residential properties acquired before the application date, with officials to consult on the details of this rule.

50 Limiting interest deductions will support our second objective for the housing market. It will put downward pressure on house prices and decrease the tax advantage held by debt financed property investors. Reducing the amount of money debt financed investors are prepared to pay for properties will support first home buyers. As with the bright-line extension, we acknowledge there is a risk that some landlords could sell their property, potentially displacing tenants (but opening up the opportunity for first home buyers to purchase the property), or increase rents. But, as noted above, the Government is looking at options to mitigate the risk of rent increases.

51 There are two options for the application of denying interest deductibility on which we are seeking an in-principle decision from Cabinet:

51.1 Option A: limit interest deductions prospectively for income earned from residential property acquired and loans relating to residential property drawn down on or after the application date; or

51.2 Option B: limit interest deductions in full for income earned from residential property acquired and loans relating to residential property drawn down on or after the application date, and phase out interest deductibility for properties acquired before this date through a transitional rule.

52 Option A does not change the tax treatment of loans relating to an asset purchased under previous settings that were in place before the measure was reformed.

53 Under Option B, the immediate impacts on existing property investors are reduced relative to immediately limiting interest deductions in full, which mitigates against short-term disruptions to tenancies and large-scale exiting from the market. Progressively phasing out the deductibility of interest payments will result in all property being placed on an equal footing in terms of tax treatment, rather than creating two classes of assets depending on the date of acquisition of the property. This option would also have a far greater impact on property investors' behaviour, and therefore on the Government's housing policy objectives, through its eventual application to the total stock of houses held by investors. However, there is still a risk to tenants as some landlords

(particularly those that are highly-leveraged) may still increase rents or divest properties, displacing tenants.

54 We intend to announce Cabinet's in-principle decision and consult on the design of the measure. We will return to Cabinet for further decisions on its design, following consultation. Annex B below gives an example demonstrating the effect of this measure.

55 With respect to the application date, there are two options (as with the bright-line extension), set out in paragraph 101 .

56 This measure could also affect incentives to build new homes; for this reason, a further option on this proposal is whether it should also contain an exemption for investment in newly built houses (see below).

57 Limiting interest deductions is a significant change to the tax system and will materially increase costs for highly leveraged investors. It is complex, and more work is needed to fully understand the likely compliance costs. We consider it justified to reduce investor demand by removing a tax advantage held by property investors, in order to support first home buyers. Stakeholder consultation will help us to determine the implications of this measure.

58 If Cabinet makes a final decision to proceed, it is proposed the rule applies for interest incurred from 1 October 2021.

Exemptions for newly built property

59 As noted above, the Government's priorities are to support more affordable house prices and increase opportunities for first home buyers by dampening speculative investment in the existing market, while incentivising investment in the supply of new housing. There is a risk that the proposed change to the bright line test – if applied to existing investment property and new-build investment property – would have the effect of disrupting the existing pipeline of property and land development by reducing short-term demand and the finance available to property developers. Almost 40% of new-build properties were purchased by multiple property owners (a proxy for investors) in 2020, while first home buyers accounted for 23%. First home buyers face greater hurdles to obtaining finance for new builds, because they cannot draw on existing equity as investors can, and because banks impose more requirements for mortgages on new builds versus existing houses.

60 To reduce this risk, we propose to exempt from the bright-line extension property purchased after the application date of these measures and within 12 months of the property receiving its code compliance certificate under the Building Act 2004. This 12 month period will not align with the Reserve Bank's definition of a "new build" in the reinstated LVR restrictions (which is within six months of the code compliance certificate). However, the longer time period is necessary in order to ensure that the new build exemption operates broadly enough. It will align with the definition of new builds used for First Home Grants.

61 We recommend that Cabinet considers the following two options:

61.1 **Five-year bright-line test for new builds:** Under this rule, investors in newly constructed properties acquired after the application date would continue to be subject to a five-year bright-line test. Keeping a five-year bright-line test for these investors would not disrupt the existing pipeline for the new-build market, which is based on the current five-year rule. Under the current rule, building consents experienced a record quarter in December, and the annual pipeline for building consents has risen steadily since the five-year rule was introduced.

61.2 **Complete exemption of new builds:** Alternatively, we could exempt all newly constructed properties acquired after the application date from the bright-line test.

62 We also wish to consult on whether to allow investors in newly constructed properties acquired after the application date to continue to be able to fully deduct interest costs from their rental income. [33]

62.1 [33]

62.2

63 [33]

64 Compared to applying the changes to all investment properties, a new-build exemption would lead investors (particularly debt-financed investors) to demand more newly built properties, as they will attract a tax advantage.

65 The overall impact of a new build exemption is unclear as other buyers will change their behaviour, but intuitively any impact of the tax changes on house prices, supply or rents will be smaller than without an exemption, with investor activity more concentrated in new builds. It is worth noting that first home buyers purchasing a new build will continue to have a tax advantage over investors (if investors continue to have the existing five year test applied to new builds), as the bright-line test does not apply to the family home.

66 As noted, we propose that, for a given investor, a new build will be defined as a property they acquire up to 12 months after the code compliance certificate is issued under the Building Act 2004. The burden of proof would be on the investor to prove that a property qualifies as a new build. From a compliance perspective, the code compliance certificate is the most objectively verifiable date to determine when a new property has been built. [33]

67 [33]

These measures are expected to place downward pressure on prices, but the magnitude of their combined impact is hard to predict

68 Both measures are expected to reduce the demand for housing from property investors, particularly in regard to existing housing stock. While they have different incidence – the bright-line test applies only on a property's sale, whereas limiting interest deductibility would affect the flow of income derived by investors – they both affect the return from residential property investment, and our final decisions will need to take account of the cumulative impact of the package of measures.

69 A significant extension of the bright-line test may be seen as weakening the rationale for limiting landlords' ability to deduct interest expenses, as one justification for denying interest deductions is that gains on the sale of residential property investments are generally not taxed. Denying deductions therefore reflects the general principle that expenses should only be deductible to the extent that they relate to earning taxable income. One potential area of focus for the public consultation on interest deductibility is therefore the interaction between the extended bright-line test and any potential changes to deductibility rules; specifically, whether investors who are liable to pay tax on the profits from the sale of an investment property under the bright-line test should be able to offset interest payments against those profits in the relevant income year.

70 For property developers, this justification does not apply as they are always taxed on their gains on sale. It is important not to unduly reduce housing supply by denying deductions for property developers' ordinary business expenses, and we propose to exclude developers from these measures.

We propose to increase the income caps for First Home Products (First Home Grants and First Home Loans)

71 The income caps for both First Home Grants and First Home Loans are currently set at $85,000 for single buyers and $130,000 for two or more buyers.

72 First Home Grants are intended to help first home buyers (and second chancers)[3] overcome deposit barriers. The grants are available to first home buyers who have contributed to KiwiSaver for three years or more.

73 First Home Loans are issued by selected banks and other lenders and underwritten by Kāinga Ora. This allows the lender to provide loans that would otherwise sit outside their lending standards. These allow a person to only have a 5% deposit rather than what might otherwise be required by their bank.

74 Increasing the income caps will expand the cohort of first home buyers that can access First Home Grants and First Home Loans.

75 We propose the income cap for single buyers be raised to $95,000 and the income cap for two or more buyers be raised to $150,000.

We propose to increase the house price caps for First Home Products both for existing and new properties

76 First Home Product house price caps are set so that support is well targeted at those first home buyers who need help purchasing modestly priced houses. There are different caps for existing and new properties with higher cap for new properties to support demand for new supply and dampen pressure on the prices for existing homes.

77 In many parts of the country the house price cap has begun to limit the number of houses first home buyers can buy using First Home Products. This is because lower

[3] Second chancers are also eligible for the First Home Products. However, they must not have previously received the First Home Grant and must also not have realisable assets worth more than 20 percent of the house price cap for existing properties in the area they are buying. Currently second chancers make up 7% to 10% of all grants.

quartile house prices in some places have increased above the current house price caps.

78 We propose increasing both existing and new property house price caps - increasing the price caps for existing properties by half the amount of the proposed increase for new build properties, as shown in the table below.

79 This differential rate of increase will provide increased support for those who purchase new houses, while providing a fair level assistance for those buyers who purchase existing properties. This is particularly important in areas where there is limited new supply.

Region	**Price Cap for New Properties**		**Price Cap for Existing Properties**	
	Current Cap	*Proposed Cap*	*Current Cap*	*Proposed Cap*
Auckland	$650,000	$700,000	$600,000	$625,000
Queenstown-Lakes	$650,000	$650,000 (No change)	$600,000	$600,000 (No change)
Wellington City, Hutt City, Upper Hutt City, Porirua City, Kāpiti Coast District	$550,000	$650,000	$500,000	$550,000
Nelson City, Tasman District, Tauranga City, Western Bay of Plenty District, Hamilton City, Waipa District, Hasting District, Napier City	$550,000	$600,000	$500,000	$525,000
Christchurch City, Selwyn District, Waimakariri District	$550,000	$550,000 (No change)	$500,000	$500,000 (No change)
Waikato District, Dunedin City	$500,000	$550,000	$400,000	$425,000
Rest of New Zealand	$500,000	$500,000 (No change)	$400,000	$400,000 (No change)

80 Increasing the house price caps for First Home Loans and First Home Grants increases the set of dwellings available to households who qualify for the grant and is likely to increase uptake of the scheme. Increasing price caps may cause some inflation in the market. However, this impact is likely to be mitigated by the fact that demand will increase for only a sub-set of the market - homes priced between the current and proposed price caps.

The Historic Link Between Income and House Price Caps for First Home Products

81 The predecessor to the First Home Grant (and KiwiSaver HomeStart grant) was developed from 2005 to 2009, alongside the introduction of KiwiSaver. The original income caps of $100,000 for one or two buyers and $140,000 for three or more buyers were set to ensure that:

81.1 Households have sufficient income to service a mortgage for a lower quartile priced house in 2010 and beyond; and

81.2 Households with sufficient income to service a mortgage without assistance are not eligible for the deposit subsidy.

82 These income caps were introduced alongside a house price cap of $400,000 for higher priced areas, and $300,000 for all other areas.[4]

83 The table below compares the level of pre-tax income that a household is required to spend to service a mortgage (with a term of 30 years and a 10% deposit on average) for a household:

83.1 Earning at the income cap; and

83.2 Purchasing a house at the highest price cap.

84 The table compares these factors at historical, current and proposed income and house price caps. Note that this comparison considers the different policy settings for First Home Products and approximate interest rates operating at that time.

85 With the proposed increases to the income and price caps set out below, a household buying at the top of both caps would be spending an equivalent percentage, or slightly less, of pre-tax income on servicing their mortgage compared to original caps.

Percentage of income (pre-tax) to service mortgage on house at highest price cap						
	1 Buyer	***2 Buyer***	***3 Buyers+***	***House price cap***	***Income cap***	***Interest rate***
2007 – caps first agreed	38%	38%	27%	$400,000	$100,000 1 -2 buyers $140,000 3+ buyers	10.1% p.a.
2010 – grant introduced	26%	26%	19%	$400,000		6.2% p.a.
2021 – current settings	42%	27%	27%	$650,000	$85,000 1 buyer $130,000 2+ buyers	4.5% p.a.
2021 – proposed increase to income caps and price caps	40%	26%	26%	$700,000	$95,000 1 buyer $150,000 2+ buyers	4.5% p.a.

86 When price caps were first implemented a one and two buyer household needed to spend 38% of their pre -tax income to service a mortgage (above the international benchmark of 30% for housing affordability). By 2010, due to falling interest rates and the availability of low deposit loans, this proportion decreased to 26% for one and two buyer households

[4] There was no distinction between existing and new build properties at this time. A new build price cap was subsequently introduced in 2015.

87 Currently, one and two buyer households are experiencing different levels of affordability at the price and income caps. At the current and proposed settings two buyer households can service the mortgage for less than 30% of their pre-tax income. In contrast, under current caps one buyer households are at the 42% level. As such, a modest increase in the income cap for single households would not constitute a change from the programme's mandate to support those requiring help to service a mortgage.

[33]

88 [33]

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Implementation of the measures

91 A number of important decisions are needed to finalise the measures.

Application of extended bright-line test

Prospective application

92 We propose that the extended test apply only in relation to property acquired on or after the application date, as applying it to property acquired earlier could be seen as unfair, by affecting purchases made in the past.

Application date

93 We recommend that the extended bright-line test apply to properties acquired shortly after the announcement. We note that there was a delay of approximately six weeks between announcement and application when the bright-line test was extended from two years to five years. We think the more limited delay proposed here is appropriate because of the substantial extension to the bright-line period and the heat in the current property market. Having a short period between announcement and application will limit the opportunity for people to rush to purchase property during that window. There are options for the application date:

93.1 **Option A (window between announcement and application of at least seven days):** The extended bright-line test could apply to properties acquired on or after the first Monday at least seven days after the announcement date (the **application date**). For example, an announcement on Thursday 18 March would have an application date of Monday 29 March. This ensures there is adequate time for information about the change to be disseminated, but risks an influx of buyers during this short window. The week or so delay between announcement and application means those negotiating and signing sale and purchase agreements shortly after the announcement are not unfairly affected by an announcement of which they may be unaware.

93.2 **Option B (applies after 11.59 pm on the date of announcement):** The extended bright-line test could apply to properties acquired after 11.59 pm on the date of the announcement (the **application date** will essentially then be from midnight). For example, an announcement on Thursday 18 March would have an application date of Friday 19 March. This provides minimal opportunity for buyers to shift transactions to avoid the extended bright-line test but risks unfairness if information about the change is not disseminated.

94 Under either Option A or Option B above, the extension of the bright-line test will not apply if the sale and purchase contract was entered into before the application date (whether 11.59 pm or the Monday), because the property is acquired at the point the contract is entered into (even if at the application date there are typical conditions still to be satisfied – like obtaining finance or a building report). Residential property acquired before the application date will either be outside the scope of the bright-line test or will continue to be subject to the existing bright-line period of five years depending on its purchase date.

Issue with respect to tenders and irrevocable offers

95 Separate to the question of the window between announcement and application, there is an issue with respect to tender offers that are made but not yet accepted as potential buyers may not be permitted to withdraw their offers. Under either Option A or B above, we could add an additional qualification that the extended bright-line test "will not include properties acquired as a result of an offer made before the end of the day of announcement". This would ensure that tender offers made on or before the announcement date would not be subject to the extended bright-line test, regardless of when that offer is ultimately accepted.

Other proposed changes

96 We are proposing that the settings for the bright line test largely remain the same, with minor exceptions. Some existing policy settings for the bright-line test that do not cause issues in the context of a two-year or five-year rule could lead to anomalous results under an extended rule, whether it is 10, 15 or 20 years. We propose that the following rules be amended at the time the extension is implemented, in relation to residential property acquired on or after the application date.

96.1 **Definition of "residential land":** Land predominantly used as business premises is excluded from the residential land definition and is therefore not subject to the bright-line test. We recommend that the business premises exclusion be amended to explicitly exclude the provision of short-stay accommodation in a dwelling that is not the owner's home. The term "residential land" is also used in the rental loss ring-fencing rules which limit an investor's ability to offset rental losses against other income. For the bright-line test, this change will apply for properties acquired after the application date, but for the rental loss ring-fencing rules it would apply for the 2021–22 and later income years, regardless of when the property was acquired.

96.2 **Change of use:** A person's main home is not taxed under the bright-line test. Property that is rented some of the time is exempt if it is used as the owner's main home for more than 50% of the period the property is owned. With an extension, we propose that the main home exclusion apply only for the period when the property is actually used as the owner's main home. This measure would allow for a 12-month change of use buffer within which the property can be moved into or sold without accounting for the change.

96.3 Taxpayers who change the use of the land during the bright-line period would be given the option to pay tax based on either the actual increase in value during the time the land was not their main home, or on a proportional basis as a low compliance cost option. For example, assume there is a 20 year bright-line test and a residential property is acquired in 2022 for $800,000 and occupied as a main home until 2030. In 2030, the owner moves out but keeps the property as a rental property. At that time the rating valuation indicated that the property was valued at $1.3 million. In 2035, the property is sold for $1.5 million. The main home exclusion will apply for the eight years from 2022 to 2030. However, tax will be payable on the gain in value while the property was used as a rental property (i.e. the five years from 2030 to 2035). The owner can choose to pay tax on the proportional gain on sale (being 5/13th of the total gain, or $269,230), or on the actual gain over the time the property was not the main home (being $200,000).

97 Officials will provide further advice on several other aspects of the current bright-line test that may not remain fit for purpose with an extension. This includes issues relating to family transfers, Māori land (including the treatment of inherited Māori land), compulsory acquisitions, business restructures, deductions for holding costs, the interaction with the rental loss ring-fencing rules, specific anti-avoidance rules, and residential land withholding tax. As these issues are complex, officials will undertake consultation before returning to Cabinet to seek further design decisions, and including these changes in a Bill expected to be introduced in September 2021.

98 Since the introduction of the bright-line rules in October 2015, Inland Revenue has been continually working to improve compliance. Inland Revenue utilises its new analytical tools to review all residential property transactions to estimate the bright-line compliance and identify compliance risks that need to be addressed. Inland Revenue's current focus is reaching out to the right customers at the right time, with the right information, to help them voluntarily comply with the bright-line test. An example of this is the recent bright-line compliance campaign where approximately 12,000 customers were contacted about their potential bright-line obligations.

99 Inland Revenue's compliance strategy has been evolving and would need to be adapted once the detailed design is confirmed. Consideration will need to be given to additional information requirements, compliance costs to customers and any resourcing implications as part of the next phase of delivery.

100 Further work, in consultation with Land and Information New Zealand, will be undertaken to determine what changes to the Land Transfer Tax Statement could be appropriate to support the changes to the bright-line test.

Limiting interest deductions for income earned from residential property

101 Our intention is to announce an in-principle decision to limit interest deductions for income earned from residential property, pending consultation, with the rule to take effect from 1 October 2021. In order to announce this decision and convey the new rule's parameters to the public, we consider the following issues require decisions from Cabinet at present:

101.1 **Application date.** There are two options for the application date set out below. These are in line with the options for the extended bright-line test discussed above:

- **Option A:** Deductions would be limited for loans relating to residential property acquired or loans relating to residential property drawn down on or after the first Monday at least seven days after the announcement date.
- **Option B:** Deductions would be limited for loans relating to residential property acquired or loans relating to residential property drawn down after 11.59 pm on the date of the announcement.

102 As with the extended bright-line test, we could add an additional qualification that the new rules on interest deductions "will not include residential property acquired as a result of an offer made before the end of the day of announcement". We also propose that the rules ensure that if a property is acquired as a result of an offer made before the announcement date (including offers accepted where settlement has not yet occurred), interest deductions for any loan used to acquire that property will be allowed or subject to phasing (depending on the transitional rule below), even if the loan is not drawn down until after the application date.

102.1 **Size of the denial.** It is proposed that interest deductions be denied in full for loans relating to residential properties acquired on or after the application date, and the draw down of new loans for existing property. Cabinet is asked to consider if interest deductions should be denied for existing loans, with phasing in of the denial for existing loans (see option B below).

102.2 **Transitional rule.** Cabinet is asked to decide between two broad types of transitional rule for properties acquired before the application date:

- **Option A: The change is prospective only.** Interest would only be denied for loans relating to residential properties acquired, or loans relating to residential property drawn down, on or after the application date. In this case the new rules would not affect interest in respect of loans relating to residential properties acquired before the application date. This means the amount of deductions denied (on an aggregate basis) would initially be significantly less than the full amount of interest currently claimed. Applying the rule prospectively avoids impacting those who made decisions before the application date, reducing the risk that existing landlords will disinvest and terminate existing tenancies. It will also reduce the impact of the measure on prices and rents. That said, this transition rule advantages those that already own property (particularly when combined with a prospective extended bright-line test), which may create inter-generational equity concerns. It also creates a lock-in effect due to the incentive to retain properties purchased before the rule came into effect, at the expense of other potentially higher value investments.
- **Option B: The change is phased in over 10 years for those who acquired property with a loan before the application date.** Under this approach, interest would be fully deductible on such property prior to 30 September 2021, 90% deductible for the remainder of the 2021–22 income year, 80% deductible for the 2022–23 income year and so forth. This slow phase-in would tend to minimise the effects on those who purchased property prior to the application date but not as completely as a fully prospective rule. At the same time, it will have greater housing market impacts while raising fewer inter-generational equity or lock-in concerns. Clearly, options A and B are only two among a broad set of possible options and other slow rates of phase-in could also be considered.

103 Several other detailed design decisions are required to implement this change, including on the following matters:

103.1 This change could impact non-housing loans (which includes loans for small businesses secured by residential property). It is not the Government's intention to apply this rule to non-housing loans. This issue relates to interest allocation, which is complex and will be worked through by officials in consultation with stakeholders.

103.2 Rules will also be needed for working out when interest deductions should be limited for loans drawn down after the application date, if the property it relates to was acquired before application date. This is also a type of interest allocation issue.

103.3 As noted above, extension of the bright-line test could be seen to reduce the rationale for limiting interest deductibility. We propose to direct officials to consult on whether any allowance for interest deductibility should be provided where a property investor is taxed on sale under the bright-line test or otherwise.

First home products

104 Kāinga Ora have advised they would require a minimum of 15 working days to implement the First Home Product changes. We therefore propose these take effect from 1 April 2021.

Financial Implications

105 Extending the bright-line test will raise revenue in the longer-term. The extension has no forecast financial implications within the forecast period, which is already covered by the five-year bright-line test. The bright-line test extension is intended to prompt behavioural changes from prospective investors by discouraging entry into the market for existing property, which would reduce any potential longer-term revenue. However, this is hard to model and therefore is not included in the longer-term projections.

106 Exempting new builds from the bright-line test altogether will result in forgone revenue within the forecast period and out-years. However, officials have not had sufficient time to quantify this foregone revenue. Officials are preparing estimates of the foregone revenue and will provide these estimates to the Minister of Finance and Minister of Revenue.

107 In the time available, officials have not estimated the impact on revenue from a limitation on interest deductibility. Such estimates will rely critically on the design decisions. Officials will provide us with revenue estimates when design decisions are made post-consultation.

108 If the proposals in this paper lead to higher rents for lower-income New Zealanders, then this may increase expenditure on the Accommodation Supplement and Temporary Additional Support. It is difficult to quantify this impact at this stage.

109 The impact of increasing the new and existing house price caps for First Home Products is estimated to cost $12.3 million per annum.

110 Increasing the income caps is likely to increase the cost of the First Home Products. Estimating this cost is complex. One of the main problems is that increasing the income caps does not actually increase the number of homes available below the income caps. Additionally, data suggests that the first home buyers are buying houses above the current house price cap.

Administrative implications

111 While the stock of properties potentially subject to the extended bright-line rules will increase over time, through efficiencies and savings, Inland Revenue can absorb the additional costs from administering the extension.

112 However, limiting interest deductions will involve increased administration costs for Inland Revenue over an extended period of time while different rules based on the acquisition date of properties continue to be in place. These costs will arise from managing an increased number of customer contacts and supporting the integrity of the rules by adopting a "right from the start approach". This means a mixture of providing people with information to increase awareness and making sure that Inland Revenue uses its full range of enforcement measures and will involve:

112.1 Ongoing proactive marketing and targeted education campaigns, followed by one-on-one interventions such as community compliance visits and integrity checks;

112.2 developing appropriate tools to assist customers to determine eligibility;

112.3 improving Inland Revenue's data and analytical capability; and

112.4 taking audit action to address deliberate non-compliance.

113 We will work with Inland Revenue on a required funding proposal to support implementation of final decisions on interest deductibility. Inland Revenue could re-prioritise existing compliance work programmes. This would reduce effort in other areas where baselines have reduced significantly over time.

114 Kāinga Ora are responsible for administering First Home Products. Kāinga Ora and participating financial institutions will need to reflect these proposed increases in their practices and communications material

Legislative implications

115 The bright-line extension and associated changes can be included in a Supplementary Order Paper (SOP) at the Committee of whole House stage of the Taxation (Annual Rates for 2020–21, Feasibility Expenditure, and Remedial Matters) Bill (the Bill). The Committee of the whole House stage of the Bill is scheduled for the week of 16 March and enactment by 31 March 2021. Whether a separate stand-alone Bill can be introduced is being considered.

116 A complete exemption from the bright-line test for new-build properties (para 61.1) would be included in the SOP as a full exemption would be immediately applicable to property purchases from the application date.

117 Retaining a five-year bright-line for new-build properties (para 61.2) will not be able to be included in this SOP but will be included in the omnibus tax Bill scheduled for introduction in September this year. While this may affect purchases in the intervening period, this is necessary as legislative design is complex.

Regulatory Impact Statement

118 The Treasury's Regulatory Impact Analysis Team and Inland Revenue have reviewed the Regulatory Impact Statement (RIS) "Tax measures to moderate house price growth – extension of the bright-line test" produced by the Treasury and dated 5 March 2021. The review panel considers that it partially meets the Quality Assurance criteria.

119 While realising that the tax system is not the primary driver of housing affordability, the Treasury has identified a number of options to help partially address the housing problem. The Treasury's preferred option is to extend the bright-line test from 5 years to 20 years with no exemption for new builds. A framework with a comprehensive set of criteria has been developed to assess these options. However, limited consultation has been undertaken due to significant time constraints.

120 The denial of interest deductions is another policy option that has been identified, but in the time available, the Treasury has not been able to undertake impact analysis. Further, no analysis has been undertaken on how this measure would interact with the extension of the bright-line test. The Treasury has agreed that a Supplementary Analysis Report (SAR) relating to this proposal will be incorporated into an upcoming consultation process. After this consultation, a full RIS will be produced for the final policy decision at the Cabinet.

121 There is also no RIS to accompany the proposal relating to Residential Tenancies Act. Once the regulatory proposal returns from consultation a RIS may be required.

Treasury comment

122 The Treasury's view is that increasing income caps for First Home Products strengthens a regressive redistribution policy and will likely cause inflation in an already heated housing market. Existing income caps ($85,000 for one-buyer and $130,000 for two-buyers) are above median household incomes for the same cohorts and target households in the top 10-40% of income earners. As such, this intervention helps high income earners as opposed those on modest or median incomes. Increasing income caps will also have significant inflationary impacts on the lower end of the housing market as demand will increase for all houses under the price caps. This affects potential buyers in the lower end of the market regardless of whether they are using the scheme. This is likely to have a negative impact on first home buyers who are most active in the bottom 30% of the market.

Inland Revenue view

123 Inland Revenue recommended against both extending the bright-line test and denying interest deductibility.

124 With the bright-line extension, a key concern was that many investors might pay substantial amounts of tax if they sold properties within the bright-line period but receive the gains tax free if they held the properties for a longer period. Inland Revenue considered that this would have a substantial lock-in effect – encouraging people to hold on to properties even if this would not otherwise be sensible. Higher compliance costs and economic inefficiencies through lock-in effects might be viewed as a natural consequence of raising tax, but Inland Revenue's view was that they would likely be particularly inefficient if, often, no tax ends up being raised because properties are held for more than the bright-line period.

125 Inland Revenue was concerned that denying interest deductibility has very little international precedent and can lead to high taxes on heavily geared investment property not only relative to owner-occupied property but also relative to most other investments, and relative to equity investment in rental properties. Inland Revenue was of the view that it was not a well-targeted counter to the non-taxation of capital gains, because it would over-tax rental properties that are debt funded when there are no capital gains, and not address under-taxation of rental properties that are equity funded when there are capital gains.

126 Inland Revenue considered that there was a good reason to exempt new builds from interest denial and extended bright-line to minimise adverse impacts of the measures in reducing the supply of new housing. However, Inland Revenue does not support having a new build exemption to the existing five year bright line as, prior to the first bright-line test of two years being introduced, there was evidence of investors buying off the plan and selling within two years and arguing that they did not have an intention of selling when they purchased. Inland Revenue supports retaining the five year bright line for new builds, or having at least a two year bright line for new builds.

Ministry of Housing and Urban Development view

127 The Ministry of Housing and Urban Development supports an exemption for new builds from both measures to minimise the impact on the new supply of housing. Maintaining and increasing new supply is critical to addressing housing affordability (for both rental and home ownership) in the medium term.

128 The Ministry of Housing and Urban Development does not support denying deductions to investment properties already owned at the time of announcement. Denying interest deductions to existing investment properties is likely to result in increases in rent or the sale of properties by landlords who have significant debt (leading to displacement of renters, and "churn" in the rental market).

129 [33]

Population Implications

130 The following population groups are likely to be particularly affected by the proposals in this paper:

130.1 There are differing views on the likely impact of these measures on rents. To the extent that the policy proposals within this paper place upward pressure on rents, this appears more likely to disproportionately impact Māori and Pacific people, who are less likely to own their home (or hold it in a trust) than other ethnic groups. In 2018, the proportion of Māori and Pacific people living in owner-occupied homes were 47.2% and 35.1% respectively, compared to the total population figure of 64.3%. Government is taking other measures to improve housing for Māori and Pacific, including through Progressive Home Ownership, MAIHI partnerships and our Public Housing build programme. In addition, as around 43% of children are living in rental accommodation, upward pressure on rents could have negative impacts on child wellbeing and child poverty.

130.2 Given that declining home ownership rates have been sharper amongst younger people, upward pressure on rental prices risks particularly affecting this group. Balanced against this is the potential for increased affordability for first home buyers, including among young people.

131 As noted above, the magnitude of the effect of the two measures on property and rent prices is uncertain. Accordingly, the size of the impact on population groups described above is also uncertain.

Human Rights

132 We are planning to seek Bill of Rights Act advice from the Ministry of Justice on the Supplementary Order Paper containing the bright-line extension and associated changes once it is drafted.

Consultation

133 Consultation has occurred across the Treasury, Inland Revenue, the Ministry of Housing and Urban Development, the Department of the Prime Minister and Cabinet and, on certain aspects, Land Information New Zealand, the Reserve Bank of New Zealand, and Kāinga Ora.

134 Given the need to act swiftly in response to a rapidly evolving situation, consultation with external stakeholders has not occurred. Officials will conduct consultation with external stakeholders on detailed design decisions that are still be made, including on limiting interest deductions and the design of the new build exemption.

Communications

135 Our intention is to announce these measures around mid-March. As housing affordability is of high public concern, any new measures will be of considerable media and stakeholder interest. These measures are likely to be of particularly high interest given housing interests are varied and often adverse. Investors and the property sector will expect clarity on these measures, and decisions made on consultation and timing of implementation will be of high interest.

136 We will work with officials to ensure that, as far as possible, at the time of announcement sufficient information is available to satisfy the demand for details.

Recommendations

The Ministers of Finance, Housing and Revenue recommend that Cabinet:

1 **note** that these measures form part of the Government's broader response to housing affordability;

2 **note** this paper was preceded by the paper "Housing Policy and the Reserve Bank", which also formed a part of the Government's broader package of work to improve housing affordability;

3 **note** that this paper sits alongside the accompanying paper "Increasing housing supply and improving affordability for first home buyers and renters", which is a supply-side package to increase the pace and scale of housing delivery (particularly of affordable housing for both rent and home ownership);

Objectives for the housing market

4 **confirm** that the Government's overarching policy objectives for the housing market are to:

4.1 Ensure every New Zealander has a safe, warm, dry, and affordable home to call their own – whether they are renters or owners;

4.2 Support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers;

4.3 Create a housing and urban land market that credibly responds to population growth and changing housing preferences, that is competitive and affordable for renters and homeowners, and is well-planned and well-regulated;

Extension of the bright-line test beyond five years

5 **agree** to an extension of the bright-line test from:

EITHER

5.1 five years to 10 years

OR

5.2 five years to 15 years;

OR

5.3 five years to 20 years;

6 **agree** that the extension of the bright-line test will apply:

EITHER

6.1 to residential property acquired on or after the first Monday at least seven days after announcement;

OR

6.2 to residential property acquired after 11:59 pm on the date of the announcement;

7 **agree** that the rule on the application date in recommendation 6 will be subject to the qualification that the extended bright-line test will not include residential property acquired as a result of an offer made before the end of the day of announcement;

8 **note** that some policy settings that apply to the five-year bright-line test could lead to anomalous results when the bright-line period is extended;

9 **agree**, therefore, to make the following high-priority changes to the bright-line test for residential property acquired on or after the application date:

9.1 amend the business premises exclusion so that it explicitly does not cover short-stay accommodation in a dwelling that is not the owner's home;

9.2 amend the main home exclusion to include a "change of use" rule, which would require tax to be paid on gains made during periods the property was not used as the owner's main home;

10 **agree** that recommendation 9.1 will apply for the purposes of the rental loss ring-fencing rules for the 2021–22 and later income years regardless of when the property was acquired;

11 **agree** to delegate to the Minister of Finance and Minister of Revenue the authority to make further design decisions of a technical nature on the extended bright-line test;

12 **note** that officials will consult on other issues that cannot be resolved in time for the Supplementary Order Paper referred to in recommendation 49 and that would benefit from stakeholder consultation, and that could be included in the omnibus tax Bill scheduled for introduction in September 2021;

Limiting deductions for interest incurred to earn income from residential property

13 **agree** in-principle to limit deductions for interest incurred to earn income from residential property;

Denial of interest deductions in full for new purchases

14 **agree** in-principle that interest deductions will be denied in full against the income from residential property investment for loans relating to residential property acquired on or after the application date;

Application date

15 **agree** in-principle that the application date will be:

EITHER

15.1 the first Monday at least seven days after announcement;

OR

15.2 after 11:59 pm on the date of the announcement;

Date from which denial of interest commences

16 **agree** in-principle that interest deductions will be denied for interest incurred on or after 1 October 2021;

Offers made before the announcement date

17 **agree** in-principle that the rule in recommendation 15 will be subject to the qualification that residential property acquired on or after the application date as a result of an offer made before the end of the day of announcement will be subject to the treatment in recommendation 22, even if the loan in respect of that offer is drawn down on or after the application date;

Property acquired before the application date

18 **agree** in-principle that residential properties acquired before the application date will be subject to the treatment set out in recommendation 22, even if the loan in respect of that offer is drawn down on or after the application date;

Other design decisions

19 **agree** in-principle that property developers should be allowed to continue deducting their interest expenses as incurred;

20 **agree** in-principle that officials will consult on whether interest deductions should be denied or merely deferred if the taxpayer is not a property developer but is taxed on the disposal of their property under the bright-line test or another land sale rule;

21 **direct** officials to consult with stakeholders on the design details of the interest limitation proposal before seeking final decisions from Cabinet;

Applying interest deductibility to existing properties or just future purchases

22 **agree** in-principle to one of the three following transition rules for residential properties acquired before the application date (including the properties described in recommendations 17 and 18):

EITHER

22.1 the change is prospective only, so there will be no interest denial for loans relating to the property that are drawn down before the application date *(option A)*;

OR

22.2 interest denial be phased in at a rate of 10% per annum for loans drawn down before the application date, so interest expense incurred prior to 30 September 2021 will be fully deductible, interest expense incurred in the remainder of the 2021–22 income year will be 90% deductible, interest expense incurred in the 2022–23 income year will be 80% deductible and so forth *(option B)*;

OR

22.3 phasing of interest denial as otherwise indicated, at ____% per year over ____ years (*option C*).

Draw down of loans with respect to property acquired before the application date

23 **agree** in-principle that further borrowing against residential property drawn down after the application date, if it relates to residential properties acquired before the application date (or treated as though they were acquired before the application date), will be subject to the treatment in recommendation 14 (full denial), and officials will consult on the details of this;

New build exemption to the extended bright-line test

24 **agree** to exempt property located in New Zealand purchased on or after the application date and within 12 months of receiving its code compliance certificate issued under the Building Act 2004, from the bright-line extension;

25 **agree** that a new build exempt from the bright-line extension under recommendation 24 will be subject to:

EITHER

25.1 the existing five-year bright line test;

OR

25.2 a full exemption from the bright-line test;

26 [33]

27

28

New build exemption to the in-principle decision on interest deductions

29 **agree** in-principle for officials to consult on whether to exempt property purchased in New Zealand on or after the application date, and within 12 months of receiving its code compliance certificate issued under the Building Act 2004, from limitations on the deductibility of interest;

30 [33]

30.1 [33]

[33]

30.2 [33]

[33]

30.3 [33]

31 [33]

First Home Products (First Home Grants and First Home Loans)

32 **agree** to increase the income caps for First Home Products to $95,000 for single buyer and $150,000 for two or more buyers;

33 **agree** to increase the house price caps for First Home Products for both existing and new properties as shown in the table below:

Region	**Price Cap for New Properties**		**Price Cap for Existing Properties**	
	Current Cap	*Proposed Cap*	*Current Cap*	*Proposed Cap*
Auckland	$650,000	$700,000	$600,000	$625,000
Queenstown-Lakes	$650,000	$650,000	$600,000	$600,000
Wellington City, Hutt City, Upper Hutt City, Porirua City, Kāpiti Coast District	$550,000	$650,000	$500,000	$550,000
Nelson City, Tasman District, Tauranga City, Western Bay of Plenty District, Hamilton City, Waipa District, Hasting District, Napier City	$550,000	$600,000	$500,000	$525,000
Christchurch City, Selwyn District, Waimakariri District	$550,000	$550,000	$500,000	$500,000
Waikato District, Dunedin City	$500,000	$550,000	$400,000	$425,000
Rest of New Zealand	$500,000	$500,000	$400,000	$400,000

34 **approve** the following change to appropriations to provide for changes in recommendation 33 above with a corresponding impact the operating balance and net core crown debt

	$m – increase/(decrease)			
Vote Housing and Urban Development Minister of Housing	**2021/22**	**2022/23**	**2023/24**	**2024/25 and outyears**
Benefit or Related Expenses: First Home Grants	12.300	12.300	12.300	12.300

35 **agree** that the expenses incurred under recommendation 34 above be a pre commitment against the Budget 2021 Operating Allowance;

36 **note** that changes to the income caps in recommendation 32 above may require additional funding in future but are difficult to quantify at this stage.

37 **agree** that recommendations 32 and 33 apply from 1 April 2021.

Residential Tenancies Act 1986 proposal for consultation;

38 **note** the Residential Tenancies Act 1986 limits rent increases to once every 12 months per tenancy;

39 **direct** Ministry of Housing and Urban Development officials to consult on the proposal to limit rent increases to once every 12 months per property (instead of per tenancy) and to report back to joint Ministers of Housing and Finance, and Associate Minister of Housing (Public Housing) with their findings from that process;

Population implications

40 **note** that housing costs are greater for renters than homeowners, and that the proposals in this paper risk leading to increased rents, which could have negative impacts on child wellbeing and child poverty;

41 [33]

42 **note** that officials at the Ministry of Housing and Urban Development will monitor market impacts and in particular rental markets closely and propose further measures to protect renters if necessary;

Financial implications

43 **note** that extending the bright-line test is not expected to raise revenue within the forecast period but is expected to raise revenue beyond the forecast period;

44 **note** that exempting new builds from the bright-line test will result in forgone revenue within the forecast period and outyears, and that officials have not had sufficient time to quantify this;

45 **note** that officials are preparing estimates of the foregone revenue and will provide these estimates to the Minister of Finance and Minister of Revenue;

46 **note** that limiting interest deductions will raise revenue within the forecast period. Officials will provide an estimate of this revenue when we make final design decisions;

47 **note** that if the proposals in this paper lead to higher rents for lower income New Zealanders, then this may increase expenditure on the Accommodation Supplement and Temporary Additional Support, although it is difficult to quantify this impact at this stage;

48 **note** that Ministers will work with Inland Revenue on a required funding proposal to support implementation of final decisions on interest deductibility.

Legislative implications

49 **agree** to delegate authority to the Minister of Revenue, in consultation with the Minister of Finance and the Leader of the House, to release a Supplementary Order Paper containing the measures in recommendations 5 to 11 and 25.2 at the Committee of the whole House stage

of the Taxation (Annual Rates for 2020–21, Feasibility Expenditure, and Remedial Matters) Bill.

Authorised for lodgement

Hon Grant Robertson
Minister of Finance

Hon Dr Megan Woods
Minister of Housing

Hon David Parker
Minister of Revenue

Annex A: Impact of interest denial proposal

Example:

Jane has $1 million after selling previous investment properties and is thinking about using this money to help purchase five $500,000 properties (total purchase price of $2.5 million). Jane has budgeted her investment as follows:

- Loan: Take out a $1.5 million loan at an interest rate of 2.5% (plus $1 million deposit to cover the $2.5 million purchase price).
- Loan repayments: The loan is interest-only and so Jane expects to pay around $37,500 in annual interest expenses.
- Other expenses: Jane budgets to pay around $30,000 in other expenses (e.g. rates, insurance maintenance).
- Rent: Jane expects to rent out each property for $300 per week, earning $78,000 each year.
- Other income: Jane has a $90,000 salary from her job and so she has a marginal tax rate of 33%.

Before tax, Jane is expecting to have positive cash-flow of $10,500 per annum ($78,000 of rent minus $37,500 interest and $30,000 other expenses).

Under current law, Jane had expected to pay $3,465 in tax ($10,500 x 33%). This would leave her with *positive cash flow of $7,035 per year* on her investment.

However, if Jane can no longer claim tax deductions for her interest expenses, then she will expect to face an annual tax bill of $15,840. This means she now expects to have *negative cash flow of $5,340 per year* on her investment.