Proud providers of rental homes

Submission to the

Deputy Commissioner, Policy and Regulatory Stewardship, Inland Revenue Department

on the

"Design of the interest limitation rule and additional bright-line rules"

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New Zealand Property Investors' Federation

This New Zealand Property Investors' Federation Inc (NZPIF) welcomes the opportunity to provide feedback on the Design of the interest limitation rule and additional bright-line rules.

Established in 1983, the Federation has eighteen affiliated local associations throughout New Zealand. It is the national body representing the interests of over 7,000 property investors on all matters affecting rental housing.

Our philosophy is to be an industry advocate, which means we take a balanced role in considering the rental industry as a whole, including the requirements, rights, and responsibilities of both tenants and rental property owners.

Industry Background

There are approximately 290,000 landlords in New Zealand. There are no corporate or institutional residential landlords.

There are approximately 603,500 residential rental properties, housing over 1,500,000 tenants[1], with a national median price of $820,000[2].

Private landlords are the largest providers of rental accommodation in New Zealand. 87% of tenants rent from a private landlord or trust.

Most property investors (57%) have been engaged in the business for 10 or more years[3], which dispels the myth that people are investing in property to make a "quick buck". Instead, property investors are using their rental income business as a mechanism for saving for retirement and are professional and committed long-term service/accommodation providers.

There were 22,521[4] people on the Public Housing Register in December 2020.

The rental property industry paid tax on net rental income of $1,444,000,000 in the 2016 financial year[5]

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[1] 2020 Statistics NZ – Housing in NZ 2020

[2] REINZ Monthly Property Report May 2021 REINZ.

[3] ANZ NZPIF Annual Survey 2006

[4] Public Housing Quarterly Report, December 2020

[5] IRD Data, April 2018

SUMMARY

In March 2021, the Government released housing policies with a goal to encourage more sustainable house prices by dampening investor demand for existing housing stock and to improve the affordability for first home buyers as an attempt to cool the housing market. The New Zealand Property Investors Federation believes that these changes will ultimately increase rents due to the increased costs of providing a rental home and may in some cases cause landlords to delay maintenance of their properties. Any increase in rents, will reduce the saving ability of tenants to accumulate a deposit to purchase their own home. We do not believe that removing the ability to deduct the mortgage interest costs as a deductible expense for rental property providers is the best way to achieve the desired outcome.

Private landlords supply 87% of rental properties to some 1,500,000 tenants. From our research we believe that these tenants will face higher rents to help private rental property providers cope with the increased costs.

The extension of the Bright Line test and the removal of interest charges as a legitimate business expense are not policies that will help more first home buyers into a property. Rents will increase to help pay the additional holding costs, thus making it harder for tenants to save a deposit for a home.

We recommend more time to work out the effectiveness of these changes to achieve the desired goals and an understanding if these changes will do more harm than good as a long-term solution to get more first home buyers into owner-occupier homes. One major impact we believe is that a tiered housing market will be established between properties that can have the interest deductibility claimed and those that can't, so care will need to be taken that market fragmentation does not occur.

Government departments have had little time to perform impact statements on the effectiveness of these tax changes. It also never had time to establish the unintended consequences of these, especially to house prices and rental prices and ultimately what happens to tenants. We note that policy advisors from IRD, Treasury, and MBIE advised the government not to proceed with this tax change.

NZPIF believes that due to the complexity of these changes and the limited time to get independent finance advise before the next tax returns are due the chances of non-compliance will be high and NZPIF would welcome a delay before implementation.

Although the discussion paper is extensive, the New Zealand Property Investors Federation believes that most questions are best answered by accountants and tax specialists. However, we have asked our members to send in specific situations that affect them individually.

DISCUSSION

As mentioned in the discussion paper, the Governments objectives are to balance several housing, economic, and tax policy objectives. In these discussions, it must be noted that a large proportion of the country rent a property, and now with approximately 22,500 people on the Public Housing Register we need to ensure that any changes which affect landlords, will ultimately affect our customers, the tenants. This includes increases in costs, reduction of supply, and suitability of houses.

Housing affordability

- These tax changes and extension of the bright-line will not make housing more affordable.
- In the short-term property, investors may hesitate to enter the market until the complete legislation is written.
- The expected increases in rent will make it difficult for renters to save for a deposit for their own house. In the meantime, house prices will continue to increase.
- There is nothing in this policy that will reduce the price of houses.
- Information released from Housing and Urban Development implies that 25% of current tenants could not afford to buy their own house. This would also be the case if house prices dropped.
- Private rental providers are not equipped or often not willing to change their strategy from long-term rental to property development.

Housing supply

- With the final legislation unclear and the costs of getting financial advice on how the changes will affect investors, many are hesitant to begin new building projects.
- Many investors’ have properties that can easily be subdivided and another house build on the back section. Knowing that this Government can change the rules overnight will create a lot of hesitation to begin such projects.
- Despite new build rental properties being exempt from the new tax, a NZPIF survey showed that many would prefer to invest in commercial property, property syndicates, or shares before building new rental properties.
- Investors are very cautious when considering their next purchase of an investment property.
- Older properties, which are still essential to house people, owner may delay maintenance to help with increased costs.
- With the Bright Line extension, this will create a ‘lock-in’ effect where the property is not being used to its fullest potential.
- The legislation will favour specific cohorts of landlords due to proposed exemptions ultimately favouring institutional rather than individual rental accommodation providers with significant and potentially adverse social consequences such as building complexes rather than homes. It must be noted that many of the community housing providers lease their properties from private landlords.
- What implications will these policies have when the market changes – boom currently to bust – which is evitable? Research needs to be undertaken.
- It will take years to build more houses – especially with no immigration to help labour shortages.

- Research needs to be conducted into the macroeconomics effects of these policies before implementation.
- The additional barrier put in place from removing the tax deductibility will be another hurdle for new investors coming into the market. This is unwelcome when we have a rental crisis through a shortage of available rental properties.

Efficiency

- The new tax will affect the efficiency of investment allocation as it favours all other investment options over that of existing rental property.
- Rental property that was previously income-producing could now be loss-making due to the higher taxes.

Coherence of tax system

- To single out the business of providing rental properties while allowing other similar businesses to still claim interest as a deductible expense does not seem fair.

Complexity of the tax system

- These rules will be very complex and will take a level of understanding. Individuals will require time to renegotiate financing arrangements without penalty prior to implementation. This will probably include individuals engaging with tax advisors to ensure compliance with the regime.
- There will be costs associated with engaging a tax expert for advice on interest deductibility/ apportionment where in the past these may not have been necessary.
- Tax experts will not be able to provide a standard framework even after the detail is confirmed, as tax liability will be specific to individuals.
- This regime is not fair and equal. It is comprehensive and exempts special interest group.

Interest tax deductibility

- NZPIF is opposed to the removal of interest as a legitimate tax-deductible expense for property investors.
- Interest deductibility is a standard tax provision for all businesses. Claiming that it is a loophole because homeowners cannot claim it is misleading. Homeowners get the untaxed benefit of accommodation while rental property owners get the taxed benefit of rental income, where all the revenue costs of providing that rental should be deductible.
- Our findings suggest that rents will have to increase to help landlords absorb the tax increases and continue to provide rental properties for tenants. This will reduce rental affordability for tenants.
- Higher rental prices will make it harder for first home buyers to save a deposit for their first home.
- People may look at alternative investments rather than property. This will increase demand for the remaining properties and reduce the supply of houses available for tenants to rent, thus increasing homelessness.

- Landlords often do not have the ability to change their investment strategy from providing a rental property to being a developer.
- Mum and Dad investors amount to a large proportion of providers of the 85% of rental homes and have entered the market to help subsidise their retirement. They are not, and often do not, have the ability or inclination to become a property developer.
- To change strategy to a developer requires significant funds, which are not easily to get.
- The definition of a residential home is one that has been the owner's main home for the entire time they have owned it. So, if someone decides to go on an overseas trip, they will not be willing to rent the property out. Instead, they will probably leave it empty. This will not increase housing supply.
- NZ does not have the tradespeople to build houses in mass. The market is beginning to reach full capacity even before these tax changes are implemented.

NZPIF Survey Results

In order to help fill the information gap and provide some insight into what may happen due to these policy changes, the NZ Property Investors Federation (NZPIF) conducted a survey between 29 March and 2 April 2021.

The key outcomes from the NZPIF survey are:

• 69.2% of respondents did not think they would, or hoped they wouldn't, be affected by extending the Bright Line Test.

• Just over 90% of respondents will be affected by disallowing mortgage interest to be used as a tax deduction.

• The average total extra tax per rental property owner is $15,083 per year, assuming mortgage interest rates don't increase. (On average, the respondents owned 5.3 houses each)

• This removal of mortgage tax deductibility will cost respondents an extra $3,140 a year in tax per property, assuming mortgage interest rates don't increase.

• 98% of respondents who bought a rental property in the last two years are affected with a tax increase of $4,542 per year per property, with 78.8% of those investing for 20+ years being affected at a cost of $2,468 per year per property.

• The main way to cope with the tax increase (76.8% of respondents) is to increase or probably increase rental prices. A further 8.9% might increase rental prices.

• The median rental price increase is between $21 and $30 per week.

• 70.3% of respondents do not currently charge tenants full market-level rental prices. Forty percent have rental prices between $5 and $25 under market value, while 30% have rental prices more than $25 pw under market value.

While investors are concerned that large and negative events, such as death, divorce, job loss, serious injury or disease, may force them to sell their rental properties, the majority of respondents hope they will not be affected by the Bright Line extension.
The vast majority of rental property owners will be affected by removing mortgage interest deductibility.

Discussion Document

Chapter 2- Residential property subject to interest limitation

NZPIF would like an additional exemption added. This would include any property that comprises of 3 or more dwellings, that have a single owner with the properties on the one title. This exemption would include properties like apartment blocks or blocks of units which are not normally owner occupier properties. They could be properties that are single or multiple structures however they normally have several residencies under the one roof and are more inclined to be owned by investors. These properties do not compete directly with first home buyers as they are normally expensive to purchase and are larger properties.

Ways of identifying these properties would include:

- Unlikely to be used as a private owner occupier residence
- Configured as separate dwellings or flats.
- Include three or more dwellings on the same title.
- Single title.
- Often are treated differently by council - extra rates charges, waste water, stormwater or water supply surcharges
- Often have specific description on the property title e.g. residential rental flat
- Purpose built as residential units.
- Multi-unit occupancy
- Often larger and more expensive than other properties.

There are significant barriers to convert multi-tenancy properties for owner occupier use. Without separate unit titles and establishing a body corporate the dwellings would not be available as owner occupier units. They typically cannot be converted as of right, being subject to survey, valuation, council consents and a solicitor to separately unit title each dwelling subject to satisfactorily navigating a number of conditions. Depending on the property, council may prescribe additional conditions to bring the property up to an appropriate standard.

The costs to convert can be reasonably high and can make it uneconomic to convert, purely to recover the tax consequence of lost deductibility. And tax outcomes should not be the driver for commercial decisions.

Exempting multi tenancy properties gives investors an asset class to invest in, which is on a level playing field with other types of investment which are deductible. An exemption will further help to take investors away from competing with owner occupiers, furthering the governments' objectives.

Not providing an exemption may impact on the ultimate resale value if the subsequent owner cannot deduct interest. Also, no exemption will likely increase the need to increase the rent in order to recover the additional tax to pay.

Exemptions are considered for student accommodation (halls of residence) and serviced apartments due to their specialised nature. Multi tenancy properties are equally different and merit exclusion in accordance with the government objectives.

Chapter 3 – Entities affected by interest limitation

NZPIF does not believe that Kāinga Ora and its wholly-owned subsidiaries should be exempt from the interest limitation rules. As tax payers, we would like to see the actual costs of this entity functioning and as such, should be treated the same as a private business.

We also do not support any other organisation such as Community Housing Providers, being exempt as this would ultimately hide the correct costs of providing a rental property.

Chapter 8 New build exemption from interest limitation

NZPIF would like to see the new build exemption be for a period of 25 years. This being half of the recognised life of a building. We would like to see this transferred to any owner no matter whether it is an owner occupier or a rental property. To have a differentiation between the two would make two separate housing markets within the one industry. We also believe that this will have practical impacts, for example, if a person develops two properties – one to live in and the other to rent – and lives in the latter while the former is being completed.

Chapter 9 Five-year bright-line test for new builds

NZPIF opposes the extension of the Bright Line Test. The Bright Line was first established as a means of ensuring tax was paid by property traders or flippers who entered the market for quick untaxed capital gains. By increasing the Bright Line test to 10 years will now capture property investors who provide rental homes for tenants and are not speculators. This increase in time can only be explained as a capital gains tax.

The Government has neither the money nor the resource to house all the people who require rental accommodation. Therefore, to increase the Bright Line test to 10 years will be another consideration for those people who wish to supply rental homes. This disincentive to provide rental homes, will reduce supply when we already have a shortage and put pressure on rental prices to increase. By increasing this to 10 years (which is a considerable amount of time) people may find other places to invest their money rather than supply rental homes for a market that is already substantially short of rental homes.

NZPIF would like exceptions for compassionate grounds, such as: relationship separation where the property cannot be transferred between entities, terminal illness and the loss of a job, where the person has to sell before the 10-year period. There is also no main home exemption for homes lived in by a Trust beneficiary only for the Trust principal settlers.

At longer than 5 years, the NZPIF believes a 'lock-in affect' takes hold, where the property would be better used for another purpose rather than being held for 10 years.

The NZPIF believe the Bright Line Test should be two years and return to its original purpose as strengthening 'purchase with intention' rules for property traders/speculators.

Alternative ways to increase supply:

Changing tax laws will only distort the market and will create more work for lawyers and accountants, however, it will not increase housing supply.

1.Give landowners the tools to increase supply

Our goal should be to swiftly increase the supply of housing. One way of doing this would be to make it easier for people to subdivide where the current infrastructure is in place. By increasing supply, it will drive down housing costs speed up building and discourage speculation. Therefore, we could encourage landowners that have a large section to subdivide or sell off part of their property to developers to build additional houses or build themselves.

At present it takes about 12 months for a house to go from the first consultation with council until the property is finished. To help with the cost of this the councils could offer a loan/subsidy which could put on the rates bill and could be paid off over the next few years.

- **Increases the supply:** There are a lot of large back sections and potential land which could be developed but council fees are extremely high and add to the cost and the risk to a potential subdivider. The average house owner does not have $50,000 to start subdividing.
- **Reduces speculation:** If that property is sold with in the 10-15 year make it so the remaining percentage would have to be repaid immediately. Discourages speculators and investors from taking quick profits.
- **Gives extra money in the bank for elderly who own large, potentially subdividable sections** and smaller sections for them to maintain.
- **Reduces cities encroaching on productive agricultural land.**
- **Spreads the effect on current infrastructure** over the whole city. Reducing the need for new roads, schools and water services.
- **Makes cheaper houses available** to both renters and first-time buyers. Expensive city fringe developments require larger expensive houses for builders to make a profit.
- **Smaller sections are suited to factory built transportable houses**, again a more efficient and cheaper housing.
- **Inner city infill** reduces transport needs and is good for the environment.
- **If a buyer knows there will be an extra on-going charge** on the rates may also help curb the price of sections. But at least the subsidising costs do not end up on the mortgage effecting borrowing ability.
- **Drives down house costs** – transportation to outer city developments is expensive.
- **Speeds up building** – increasing supply

Additional Comments:

- Expensive sections required an expensive house to make it economical for developers.
- Councils would still need to assess which areas the scheme could be implemented due to infrastructure concerns.
- The average number of tenants in a property have reduced over time so larger houses are not required.
- When the council develops new housing land it increases council debt. This scheme is a subsidy/debt to the housing owner direct from Government which can be at very low interest rates even though it is administered by council.

2. Follow the UK model for tax deductibility

If the Government feels compelled to change the laws on rental property mortgage interest as a tax-deductible expense, they should implement the UK model, which limits an interest claim to a 20% tax

rate, rather than completely removing it, which is the NZ proposal. The UK system has not reduced supply or increased rental prices to a significant degree, therefore, has not disadvantaged tenants.

3. Changing LVR requirements as, and when required.

We have seen from past experience that by changing the LVR requirements it can speed up or slow down the housing market. This is a low cost and effective way of changing the market and easy to reverse if required.

Final note

New Zealand Property Investors Federation would like to thank the IRD for the extensive work they have done in compiling the discussion paper on the interest limitation rule and the extension of the bright-line test.