Regulatory Impact Statement: Comparing options to support build-to-rent

Coversheet

Purpose of Document	
Decision sought:	*Analysis produced to inform Cabinet decisions on whether to provide support to the build-to-rent sector by allowing an in-perpetuity exemption from interest limitation or introduce depreciation deductions, or to retain the status quo.*
Advising agencies:	*Inland Revenue*
Proposing Ministers:	*Minister of Revenue* *Minister of Housing*
Date finalised:	*29 June 2022*

Problem Definition

There is a shortage of good quality, affordable rental properties in New Zealand. The interest limitation rules were introduced to discourage investment in residential property, and in doing so may have exacerbated this supply issue. The question is whether build-to-rent assets should be exempt from the interest limitation rules, if alternative support should be provided through depreciation deductions, or if the status quo should be retained.

Executive Summary

Problem definition

The Government's three key housing objectives are to:

a) Ensure every New Zealander has a safe, warm, dry and affordable home to call their own – whether they are renters or owners.
b) Support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers.
c) 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.

The interest limitation rules that apply from 1 October 2021 are aimed at addressing objective B by dampening investor demand. The rules address the demand-side housing objective by denying interest deductions for residential investment property. However, the rules include exemptions for new builds so as to not disincentivise investment in new housing supply, in keeping with objectives A and C above.

The current under-supply of adequate housing stock has led to a shortage of affordable rental accommodation. The build-to-rent (BTR) sector has the potential to enable significant dedicated rental supply, including the most-needed rental typologies (i.e., one- and two-bedroom units), in areas of high demand.

Possible options

Officials have been asked to compare two options to provide support to the BTR sector using the tax system.

The following options have been compared:

1. Option 1: provide an in-perpetuity exemption from interest limitation for BTR assets; or
2. Option 2: reintroduce depreciation deductions for BTR assets at a rate of 1.4%[1] diminishing value (DV).

If Cabinet decide to go with either of the above options, BTR must be defined as an asset class.

Cabinet has already agreed to a partial definition of a BTR asset class (SWC-21-MIN-0228 refers), including the following components:

a. 20 or more dwellings in a single building or multiple buildings that comprise a single development;

b. the dwellings are owned by a single owner;

c. the building/buildings that contain the dwellings may contain other dwellings or commercial premises that do not form part of the build-to-rent asset;

d. the dwellings offer tenants benefits in relation to tenure and/or rights that are greater than those provided for under the Residential Tenancies Act 1986;

e. the development includes dwellings where tenants are offered lifetime tenancies;

f. the dwellings have continuously been used as a build-to-rent since they were constructed.

There are two outstanding issues in defining the asset class - minimum tenure length requirement, and application to new or existing assets.

Inland Revenue's preferred option

Recommended option – the status quo

Inland Revenue recommends the status quo, for the following reasons:

- There is nothing inherent in BTR that makes it different from other residential rental property, apart from scale.

- While the interest limitation rules will make BTRs less attractive, the rules currently apply equally to all residential property. Inland Revenue previously advised against the introduction of the interest limitation rules, however, further exemptions for specific investment would undermine the purpose of the rules.

- The development and new build exemptions already significantly mitigate the negative impact of the interest limitation rules for newly built BTRs (completed after 27 March 2020). As with all new builds, the exemptions would apply while new BTRs are being constructed, and then for 20 years after they are completed. The new build

[1] The depreciation rate of 1.4% was chosen based on the Bureau of Economic Analysis (BEA) economic depreciation rate set for multi-use residential buildings (MURBs).

exemption would apply to the initial owner of a BTR development, as well as to any subsequent owners of the BTR during the 20-year period for which the exemption applies.

- An in-perpetuity exemption for BTRs (option 1) could be viewed as inequitable, because it would benefit large investors but provide no relief for smaller investors who hold similar properties.

- An in-perpetuity exemption would also incentivise BTRs to only ever be used as rental properties. This is contrary to the objective of the interest limitation rule, which is to tilt the playing field away from investors to first home buyers and owner-occupiers.

- Reintroducing depreciation deductions only for BTRs (options 2) would reduce fairness and efficiency within the tax system, as well as the overall coherence of the tax system. Additionally, some (but not all) BTRs are multi-unit residential buildings (MURBs). MURBs are long lived assets that in reality depreciate at a slower rate than commercial and industrial buildings.

<u>Second preference – an exemption from interest limitation (option 1)</u>

If Ministers decide to provide support to the BTR sector through the tax system, Inland Revenue recommends option 1, which would involve introducing an in-perpetuity exemption from interest limitation for BTR assets. Inland Revenue prefers option 1 as it provides a similar benefit to BTR assets as option 2, but is simpler from both a compliance and administrative perspective.

Potential impact of option 1

Of the options, option 1 is likely to provide a slightly lower net present value (NPV) tax benefit for BTR when a particular set of assumptions is applied. The NPV is based on the following assumptions:

1 the investor has a new BTR asset which is initially worth $15m

2 the investor holds the BTR asset for 50 years

3 all future deductions are discounted at a rate of 5%

4 the investor borrows 50% of the cost of the BTR asset

5 the investor pays interest of 6% per annum.

The NPV tax benefit of the extra interest deductions (beyond the benefit of the 20 year new build exemption) would be **$730,008**. The size of the NPV tax benefit of option 1, relative to the initial value of the BTR in this example, is 4.87%.

In comparison, the NPV benefit of allowing the investor to claim depreciation deductions at a rate of 1.4% (diminishing value) over the same time period would be **$879,161**. The size of the NPV tax benefit of option 2, relative to the initial value of the BTR in this example is 5.86%.

Regardless of the assumptions applied, the benefit of option 1 is relatively low. The NPV analysis for both options is also sensitive to changes in the debt ratio. For example, where the debt level is 70%, rather than 50%, the NPV of interest deductions is greater than that of depreciation deductions.

Views from consultation with stakeholders and general public

Te Tūāpapa Kura Kāinga – Ministry of Housing and Urban Development

Te Tūāpapa Kura Kāinga – Ministry of Housing and Urban Development recommends option 1: an in-perpetuity exemption for BTR developments from interest limitation rules.

The purpose of the change to interest limitation was to reduce investor demand for existing housing and improve housing affordability for first home buyers. As well as being supported by this policy, objective B is supported by other recent changes made by the Government including to the First Home Products (supports first home buyers to overcome the deposit barrier to home ownership). The Government is also addressing urban density through speeding up implementation of the National Policy Statement on Urban Development and including medium density residential standards in district plans.

The initial policy (for interest limitation) did not take into full account the diversity of residential property supply, and was mostly built around standalone properties. Emerging residential models such as BTR were not captured in this model. Subsequently, the impact on BTR and its tenants were not considered. The 20-year new build exemption is not sufficient to encourage investment in BTR, and this is likely to have a negative impact on rental supply and the experiences of New Zealanders who rent. Exempting BTR developments will support housing objectives A and C (outline above in the problem definition), in conjunction with other measures to support objective B.

The Treasury

The Treasury does not recommend an exemption for build-to-rent assets. The sector will largely be comprised of new build developments that will already receive a 20-year exemption, and there is little evidence that the sector requires additional financial support via the tax system. The sector continues to expand in full knowledge of the tax changes, and several public funding-streams are available to directly support its continued development without the complexity outlined in this paper.

Stakeholders

Some submissions to the Finance and Expenditure Committee on the interest limitation proposals were in favour of a specific exemption for BTR assets. Submitters argued that when compared with regular residential rental accommodation, BTR assets provide greater tenure security to tenants, do not compete with first home buyers and are more comparable to commercial assets (such as student accommodation or retirement villages). Additionally, they stressed that the industry will not grow without an in-perpetuity exemption from interest limitation.

Te Tūāpapa Kura Kāinga - Ministry of Housing and Urban Development convened a BTR reference group throughout 2021. This group provided input into the BTR asset class definition and an extension to the interest deductibility exemption:

- Depreciation deductibility was identified as a potential incentive to developing BTRs. Deductibility of depreciation for BTRs would be more consistent with the treatment of commercial property.

- Denying or limiting interest deductibility was characterised as a barrier to BTR development. BTR stakeholders have also been consulted in one-to-one discussions. Feedback from some institutional investors was that interest deductibility effectively determines whether investing in domestic BTR is viable, compared to international opportunities.

Limitations and Constraints on Analysis

Officials were directed to compare two options for providing support to the BTR sector using the tax system. Analysis is therefore limited to these two options and does not consider other options to support the sector.

Components of the definition of a BTR asset had already been agreed to [SWC-21-MIN-0228 refers]. There are two outstanding issues in defining the asset class (minimum tenure length requirement, and application to new or existing assets).

The impacts and costs of each option are uncertain as there is little available data on BTR in New Zealand, and limited projections on how the sector may develop. As such, it is difficult to estimate the how the sector may be impacted if support is not introduced.

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Quality Assurance

Reviewing Agency:	Inland Revenue
Panel Assessment & Comment:	The Quality Assurance panel at Inland Revenue has reviewed the *Comparing Options to Support Build-to-Rent* Regulatory Impact Assessment prepared by Inland Revenue and considers that the information and analysis summarised in the Regulatory Impact Assessment **meets** the quality assurance criteria.

Section 1: Diagnosing the policy problem

What is the context behind the policy problem and how is the status quo expected to develop?

2. **Housing affordability – supply-side issues**: Supply-side restrictions have resulted in a housing market that has not kept up with increased demand over the last 40 years. Regulatory barriers, the increased cost of building and insufficient long-term infrastructure planning makes it difficult to increase housing supply in the short term. The increased cost of building has been further exacerbated by building material shortages caused by COVID-19.

3. **Housing affordability – demand-side issues**: Demand side factors are also putting upward pressure on prices. Falling interest rates resulted in an increase in house prices, creating capital gains for existing property owners but worsening the position of prospective first-home buyers. The removal of loan-to-value ratio (LVR) restrictions by the Reserve Bank of New Zealand in response to COVID-19 allowed highly-leveraged investors to re-enter the market, thereby exacerbating price pressures. However, these have since been reinstated. High population growth has also increased demand for housing over recent decades. While tax settings are not the primary driver of housing affordability, current tax settings incentivise investment in housing. In the context of constrained supply, lightly taxing housing relative to other forms of income will lead to higher property prices than would otherwise be expected.

4. **Government objectives:** The Government currently has three key housing objectives-

   a. Ensure every New Zealander has a safe, warm, dry and affordable home to call their own – whether they are renters or owners.
   b. Support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers.
   c. 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.

5. A barrier to achieving objectives A and C is a shortage of rental accommodation driven by an under-supply of housing stock. The build-to-rent (BTR) sector has the potential to enable dedicated rental supply, including needed rental typologies (i.e., one- and two-bedroom units), in areas of high demand.

6. **Status quo**: BTR assets are treated the same as any other residential investment property. Interest deductions are being phased out from 1 October 2021 for existing residential investment properties. New builds will have an exemption from the interest limitation rules for 20 years from their date of completion. This exemption will apply to new BTR assets. Depreciation deductions are not currently available for any residential property including BTR assets.

7. **Impact of status quo on the BTR sector:** Limits to available data make it hard to predict how the sector will be impacted if no tax support is introduced for BTR. The view from the sector is that that some developments have been put on hold or deferred indefinitely as a result of the interest limitation rules. However, there are many factors at play that are making it difficult for the BTR sector to emerge at scale in New Zealand.

8. The introduction of the interest limitation rules from 1 October 2021 is seen by the BTR industry as a barrier to its expansion in New Zealand. BTR stakeholders raised concerns that without an extended interest limitation exemption, the rules would

seriously harm the feasibility of commercially delivered BTR developments. Stakeholders have indicated that they are investing elsewhere (including overseas) because of the introduction of interest limitation rules.

9. The sector has provided two arguments why interest limitation may limit the industry:

   a. First, it increases taxation and reduces cashflow for rentals. Noting that this issue is partially solved for new BTR assets, as the new build exemption will apply for the first 20 years of the asset's life.

   b. Second, it affects future sales. If a BTR asset needs to be sold, the lack of interest deductibility may affect asset value in the BTR market. BTR investors may see development in New Zealand as riskier than overseas options, or developments exempt from the interest limitation rules (such as retirement villages). Additionally, BTR assets that do go ahead may be split up and sold off as individual units after 20 years (once the new build exemption ceases) which could displace tenants.

What is the policy problem or opportunity?

10. The key policy problem is availability of rental accommodation in New Zealand. Housing costs tend to be a greater burden for renters than owner-occupiers.[2] In 2019, approximately one third of households were renters.[3] A greater proportion of lower-income households were renters, including nearly half of all households in the lowest income decile.[4] In 2020, 45 percent of renters spent 30 percent or more of their income on housing costs compared to 25 percent for owner-occupiers.[5] This high ratio of rents to incomes has been steady nationally for more than a decade.[6] However, rents have grown much faster than incomes for some groups, including renters in major centres (such as Auckland and Wellington).[7] Several factors explain increasing rent prices, including the cost of supplying rentals and increased incomes.

11. BTR provides a potential opportunity to further the Government's objectives A and C by increasing supply of long-term affordable rental accommodation. Therefore, two options for support are being considered: an in-perpetuity exemption from interest limitation, or reintroducing depreciation deductions.

12. Treatment of BTR assets would need to balance the objectives of providing new housing (objectives A and C) while not undermining the intended purpose of the interest limitation rules in terms of dampening investor demand (objective B). As BTR is an emerging industry, neither of the options are expected to provide significant financial benefit the industry, as illustrated by the NPV analysis above. However, the makeup of

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2 Stats NZ, Housing in Aotearoa: 2020, Figure 33. https://www.stats.govt.nz/assets/Uploads/Reports/Housing-in-Aotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf.

3 Stats NZ, Housing in Aotearoa: 2020, p 36. https://www.stats.govt.nz/assets/Uploads/Reports/Housing-in-Aotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf.

4 Stats NZ, Housing in Aotearoa: 2020, p 46. https://www.stats.govt.nz/assets/Uploads/Reports/Housing-in-Aotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf.

5 Stats NZ, Housing in Aotearoa: 2020. https://www.stats.govt.nz/assets/Uploads/Reports/Housing-in-Aotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf.

6 Stats NZ, Housing in Aotearoa: 2020, p 46. https://www.stats.govt.nz/assets/Uploads/Reports/Housing-in-Aotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf.

7 Stats NZ, Housing in Aotearoa: 2020, Figure 34. https://www.stats.govt.nz/assets/Uploads/Reports/Housing-in-Aotearoa-2020/Download-data/housing-in-aotearoa-2020.pdf.

BTR investors tend to be large institutional investors, so it could be seen as unfair to provide support that is not available for smaller investors who own individual residential rental properties.

What objectives are sought in relation to the policy problem?

13. As noted on 8 March 2021 (CAB-21-MIN-0045 Amended refers), Cabinet's policy objectives for the housing market are to:

    a. Ensure every New Zealander has a safe, warm, dry and affordable home to call their own – whether they are renters or owners.
    b. Support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers.
    c. 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.

14. The options presented in this Regulatory Impact Statement seek primarily to address supply-side housing objectives in support of objectives A and C. Specifically, to ensure that renters have a safe, warm, dry and affordable home to call their own. However, the options will also be considered in terms how they impact objective B.

Section 2: Deciding upon an option to address the policy problem

What criteria will be used to compare options to the status quo?

15. The options will be assessed against the three housing objectives:

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

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

    c. 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.

16. The options will also be evaluated against traditional tax policy criteria including:

    a. **Compliance costs**: options should be as simple and as low cost as possible for taxpayers to comply with.

    b. **Administrative costs:** administrative costs imposed on Inland Revenue should be appropriate for the issue.

    c. **Economic impact:** taxes should be efficient and minimise as far as possible impediments to economic growth. Options should avoid unnecessarily distorting the use of resources (that is, causing biases toward one form of investment versus another) and imposing heavy costs on individuals and firms.

    d. **Revenue impact:** options for reform should be appropriate given fiscal constraints.

    e. **Sustainability and coherence of the tax system:** options should collect the revenue required in a transparent and timely manner while not leading to tax driven outcomes, or opportunities for tax avoidance and arbitrage. Options for reform should make sense in the context of the entire tax system.

    f. **Fairness and equity:** The tax system should be fair. Options should, to the extent possible, seek to treat similar taxpayers in similar circumstances in a similar way. Consider the demographic impact where relevant, for example: on the young, poor, old, etc.

What scope will options be considered within?

Decisions by Cabinet

Options for comparison

17. Officials were directed to compare two specific options to provide support to the BTR sector using the tax system [SWC-21-MIN-0228 refers]. The first option is to provide an in-perpetuity exemption from interest limitation for BTR assets. The second option is to reintroduce depreciation deductions for BTR assets.

Definition of a build-to-rent asset

18. Cabinet has agreed to a partial definition of a BTR asset class (SWC-21-MIN-0228 refers), including the following components:

    a. 20 or more dwellings in a single building or multiple buildings that comprise a single development;

    b. the dwellings are owned by a single owner;

    c. the building/buildings that contain the dwellings may contain other dwellings or commercial premises that do not form part of the build-to-rent asset;

    d. the dwellings offer tenants benefits in relation to tenure and/or rights that are greater than those provided for under the Residential Tenancies Act 1986;

    e. the development includes dwellings where tenants are offered lifetime tenancies;

    f. the dwellings have continuously been used as a build-to-rent since they were constructed.

19. Cabinet is yet to agree on a minimum tenure length requirement to be included as part of the build-to-rent asset class definition, and whether the definition would apply to existing or new BTRs.

What options are being considered?

20. Two options are being considered in addition to the status quo:

    a. Option 1: provide an in-perpetuity exemption from interest limitation for BTR assets.

    b. Option 2: reintroduce depreciation deductions for BTR assets at a rate of 1.4%[8] diminishing value.

21. The assessment is limited to these two options. It does not analyse any other avenues of support the tax system could provide, or the other programmes that address Government housing objectives.

Status quo

22. Currently, depreciation is disallowed for BTR units (as it is for all residential buildings). Interest deductions are also being phased out over approximately four years for existing BTR assets, and interest will eventually be completely denied in relation to borrowing for BTR assets by 2025/26. BTR assets that receive their code compliance certificates on or after 27 March 2020 will be considered new builds and could qualify for the new build exemption from interest limitation for 20 years from the date they receive their code compliance certificate.

23. **Objective:** This option would not achieve objectives A and C as it provides no additional support to BTR assets, so it does not support the supply-side objectives. However, new BTR assets would still have access to the new build exemption. The status quo best achieves objective B as it does not further incentivise investor demand in residential property.

24. **Compliance costs:** This option would impose no further compliance costs.

25. **Administrative costs:** This option would impose no further administrative costs.

26. **Economic impact:** This option would have no further economic impact.

27. **Revenue impact:** This option would have no revenue impact over the forecast period.

28. **Sustainability and coherence of the tax system:** This option would be best for the overall sustainability of the tax system, as it creates no new opportunities for tax driven behaviour, avoidance, or arbitrage. It is the most coherent option in terms of the tax system.

29. **Fairness and equity:** This option has no impact on fairness and equity.

Option One – provide an in-perpetuity exemption from interest limitation for BTR assets

30. The interest limitation rules apply from 1 October 2021 to limit the ability for residential property investors to deduct interest on loans relating to residential property. Option 1 would provide an in-perpetuity exemption from interest limitation for BTR assets. The

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[8] The depreciation rate of 1.4% was chosen based on the Bureau of Economic Analysis (BEA) economic depreciation rate set for multi-use residential buildings (MURBs).

exemption would allow interest incurred in relation to BTR assets to continue to be deducted indefinitely.

31. **Objective:** Option 1 would support objectives A and C. However, for most BTR assets there will be no additional tax benefit for 20 years, as the new build exemption already applies over the first 20 years of a new BTR asset's life. It would not support objective B, as it would provide a further exemption from the interest limitation rules that aim to dampen investor demand.

32. **Compliance costs:** The compliance costs associated with option 1 are low. The interest limitation rules are complex, however, most taxpayers with BTR assets will already be interacting with the rules and applying exemptions. Taxpayers that own BTR assets would be able to continue to deduct interest costs. Taxpayers would have to determine whether they satisfy the definition of BTR as an asset class and will have to provide proof of this to the relevant government agency.[9] Taxpayers would have to consider whether their BTR assets continue to meet the definition and report any changes to their eligibility to the relevant government agency.

33. **Administrative costs:** Option 1 would have low administrative costs. It would be straightforward to administer a new exemption from interest limitation, as similar exemptions (such as the new build exemption) already exist.

34. Adding a new exemption reason to tax return forms going forward would be simple, and it should be relatively easy to collect any data required for reporting purposes.

35. There should be limited additional administrative costs for Inland Revenue associated with checking that taxpayers qualify for the BTR asset class exemption, as the relevant government agency will be providing the details of eligible taxpayers to Inland Revenue.

36. **Economic impact:** Option 1 would create a bias towards investment in BTR assets compared with other residential property. However, it would reduce the current bias against investing in BTR compared with other investments (such as commercial property), by restoring interest deductions.

37. The NPV tax benefit (when applying the assumptions set out in the executive summary) of the extra interest deductions would be $730,008. The size of the NPV tax benefit of option 1, relative to the initial value of the BTR in this example, is 4.87%.This analysis assumes the investor has an interest only mortgage with a constant debt level of 50%.

38. **Revenue impact:**

39. <u>New BTR assets:</u> This option would have no revenue impact for first 20 years after a new BTR asset receives its code compliance certificate, because the existing new build exemption would apply.

40. <u>Existing BTR assets:</u> HUD estimates there may be up to 500 existing dwellings that would not qualify for the new build exemption (existing BTR assets). If these existing BTR assets were to qualify for a BTR-specific exemption from interest limitation, this would have an estimated cost of $2.1m over the 2021/22 to 2025/26 period. Those

[9] The relevant government agency that will hold and monitor the asset class register has not yet been determined.

BTR that do not qualify for the new build exemption will be subject to the four-year phasing out of interest deductions. This means the costing for option 1 will only account for the portion of interest that would otherwise have been phased out for existing BTR.

41. After the 20-year new build exemption expires: BTR assets would continue to have interest deductions under option 1 in perpetuity from year 21. The extent to which option 1 provides a greater benefit than option 2 depends upon a number of factors, in particular the interest rate and the level of borrowing to fund the BTR asset. There is no forecast revenue impact because the reduction in revenue occurs well after the forecast period.

42. **Sustainability and coherence of the tax system:** Option 1 is better for the overall sustainability of the tax system than option 2, because it would be easier to collect data on the amount of support this option would provide to BTR assets. This better access to data would also make it more likely that Inland Revenue would be able to identify and prevent tax avoidance and arbitrage. Option 1 is less coherent than the status quo, but more coherent than option 2. There are already a number of exemptions from the interest limitation rules which provides a precedent for a BTR exemption.

43. **Fairness and equity:** Option 1 is less equitable than the status quo, but more equitable than option 2, because it provides BTR assets with an advantage over other investors in non-BTR residential properties. However, new BTR properties would qualify for the new build exemption already, so providing an explicit BTR exemption would not provide any greater advantage to new BTR assets for 20 years (at which point the new build exemption would expire).

Option Two – reintroduce depreciation deductions for BTR assets at a rate of 1.4% diminishing value

44. This would apply to both existing and new build dwellings that meet the BTR asset class definition. The rate of 1.4% is based on the Bureau of Economic Analysis (BEA) economic depreciation rate of a multi-unit residential building (MURB). Depreciation would be deductible for the life of the asset. If the asset is eventually sold for less than its depreciated value, the loss can be deducted. However, if the asset is sold for more than its depreciated value (which is more likely for residential property) the excess deductions will be included as income. This is known as depreciation clawback (or depreciation recovery income) and is an existing feature of the tax depreciation rules.

45. **Objective**: This option would support objectives A and C more than option 1. This is because most BTR assets would qualify for the new build exemption and would therefore enjoy the benefit of depreciation deductions as well as the new build exemption from interest limitation for 20 years. However, any benefit provided by allowing depreciation deductions would be reduced to the extent to which depreciation deductions are clawed back when a BTR asset is sold, so the actual benefit could be quite small. It would not further objective B as it could incentivise greater investment in residential property.

46. **Compliance costs:** The compliance costs associated with option 2 would be greater than option 1 as taxpayers would have to apply the depreciation rate. For option 1, taxpayers would just continue to deduct interest.

47. Taxpayers will have to keep accurate records of their depreciated BTR assets, so that they can calculate whether there is a depreciation loss or depreciation recovery income

when they sell their BTR asset. Taxpayers will have to ensure that any amounts of loss or income are returned, and any resulting tax liability satisfied if they sell a BTR asset.

48. Similar to option 1, taxpayers would have to determine whether they satisfy the definition of BTR as an asset class, and will have to provide proof that they satisfy the definition to the relevant government agency. Taxpayers would have to consider whether their BTR assets continue to meet the definition, and report any changes to their eligibility to the relevant governmment agency.

49. **Administrative costs:** Option 2 could have high administration costs, depending on what data needs to be collected from taxpayers.

50. If data needs to be captured on the amount of depreciation deductions claimed in relation to BTR assets, this would impose high administrative costs, because this level of information about depreciation deductions is not currently captured.

51. Similar to option 1, there should be limited additional administrative costs for Inland Revenue associated with checking that taxpayers qualify for the BTR asset class exemption, as the relevant government agency will be providing the details of eligible taxpayers to Inland Revenue.

52. **Economic impact**: Option 2 would create a bias towards BTR assets compared with other residential property, by allowing depreciation deductions for BTR when these deductions are denied for other residential buildings. However, it would reduce the bias towards investment in commercial buildings, which are able to be depreciated.

53. From year 21, interest deductions would cease because the new build exemption would expire. Depreciation deductions alone, especially taking into account any potential clawback/depreciation recovery income on sale, would provide a similar NPV tax benefit than an exemption from interest limitation.

54. The NPV benefit of allowing the investor to claim depreciation deductions at a rate of 1.4% (diminishing value) over the same time period would be $879,161. The size of the NPV tax benefit of option 2, relative to the initial value of the BTR in this example is 5.86%.

55. **Revenue impact:**

56. <u>While the new build exemption applies:</u> The revenue impact of option 2 over the forecast period, and while the new build exemption applies to new BTR assets, would be greater than the revenue impact of option 1.

57. <u>After the new build exemption expires:</u> In the longer-term, option 2 would likely have less of a revenue impact than option 1. However, the fiscal impact over the 2021/22 to 2025/26 period is estimated to be $21.2milion. The fiscal impact is greater than option 1, despite having a similar economic impact. This is because under option 1 the new build exemption applies to most BTR, and interest deductions are phased out over four years for existing BTR. This means the cost over the forecast period for option 1 only takes into account the portion of interest that is denied for existing BTR.

58. **Sustainability and coherence of the tax system:** Option 2 is worse for the overall sustainability of the tax system, as Inland Revenue does not currently collect detailed data on depreciation deductions claimed by taxpayers. Collecting additional data on depreciation would impose a high administrative burden, and absent this data it would be difficult to determine whether the depreciation rules for BTR as an asset are being applied correctly (or whether there is any tax avoidance or arbitrage occurring). Option

2 is the less coherent option, because it would involve amending the depreciation rules just to provide support for a particular type of residential investment/asset. The aim of the tax depreciation rules is to ensure that a tax deduction is available each year for the amount by which the value of an asset declines over time, not to provide incentives so that taxpayers have extra support for investments in certain types of assets.

59. **Fairness and equity**: This option is less equitable, because it provides BTR assets with depreciation deductions, and these are not available for any other residential buildings. Some (but not all) BTR assets are MURBs. MURBs are long lived assets and in reality, depreciate at a slower rate than commercial and industrial buildings.

How do the options compare to the status quo/counterfactual?

	Status Quo	Option One – *Exemption from interest limitation*	Option 2 – *Depreciation deductions*
Supply-side objective	0	+	+
Demand-side objective	0	- -	-
Compliance costs	0	0	-
Administrative costs	0	-	- -
Economic impact	0	+	+
Revenue impact	0	-	- -
Sustainability and Coherence	0	-	- -
Fairness and equity	0	-	- -
Overall assessment	0	-	- -

60. Under option 1 there would be fewer compliance and administrative costs than under option 2. Option 1 is also more coherent, equitable, and efficient, and would likely be better for the overall sustainability of the tax system. There are already exemptions from interest limitation, such as the new build exemption, and amending future tax returns forms to account for the additional exemption would be straightforward.

61. Any administrative or compliance costs associated with the BTR asset class definition would be the same for both options 1 and 2.

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

62. The status quo best meets the stated objectives overall. It promotes objective B by retaining the scope of the interest limitation rules. It also results in the most coherent and equitable tax system of all the options.

63. Inland Revenue considers that there is no inherent difference between BTR assets and regular residential property, apart from scale. To provide BTR investors with concessionary treatment would be inequitable if the same concessions are not also provided to smaller investors. Options 1 and 2 would potentially meet objectives A and C, however, there is not enough available information to conclude that either of these options would make a considerable difference to the viability of the sector.

64. Te Tūāpapa Kura Kāinga – Ministry for Housing and Urban Development considers option 1 best addresses the problem, provides the highest net benefits over the long run and that policy objective B is better met through direct support for first home buyers. It is important that Government interventions address needs for all New Zealanders, including renters.

What are the marginal costs and benefits of the option?

65. As the preferred option is to retain the status quo, there would be no additional costs or benefits of the preferred option.

66. The proposal for Cabinet (option 1 - exemption from interest limitation) would also have no extra costs or benefits to most of the sector as the new build exemption will apply to new BTR assets. The revenue impact over the forecast period would be $2.1 million if existing BTR assets were to qualify for an exemption from interest limitation.

Section 3: Delivering an option

How will the new arrangements be implemented?

68. The recommended option is to retain the status quo. This will require no implementation. The interest limitation rules have already been enacted and educational material is available.

Implementation of option 1

69. If Cabinet agrees to implement option 1, the relevant government agency would determine whether a taxpayer satisfies the BTR definition and keep a register of all qualifying taxpayers. This register will be accessible by Inland Revenue each tax year, so that Inland Revenue is aware of which taxpayers can be claiming interest or depreciation deductions for BTR assets, when these taxpayers first satisfied the criteria, and if these taxpayers cease to meet the criteria.

Implementation of option 2

70. As with option 1, a relevant government agency will need to keep a register BTR assets the meet the required definition. This would be provided to Inland Revenue who would then allow depreciation deductions for qualifying taxpayers.

71. There would be an additional complexity with implementing option 2 if data is captured on the amount of depreciation deductions claimed in relation to BTR assets. This level of information about depreciation deductions is not currently captured.

How will the new arrangements be monitored, evaluated, and reviewed?

72. There are no new arrangements recommended. However, Te Tūāpapa Kura Kāinga – Ministry of Housing and Urban Development will be monitoring the impact of the interest limitation rules on the BTR sector through regular consultation.