Navigating Taxation and Other Essentials for Residential Property Investors

David Apfel

FRS Outsourcing Limited
Tel: 021 041 0667
Email: dapfel@frsoutsourcing.com

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1. Interest Deductibility

In March 2021, the New Zealand government announced significant changes to the tax law regarding the deductibility of interest on loans for residential property investments. These changes primarily affect the ability of property investors to deduct mortgage interest expenses from their rental income for tax purposes.

1. **Phase-Out of Deductibility**: The new rule gradually phases out the ability to deduct mortgage interest as an expense against rental income. This change is aimed at cooling the housing market and giving first-home buyers a better chance against investors.
2. **Impact on Investors:** This change significantly impacts investors' returns, as mortgage interest is often one of the largest deductible expenses for residential property investments.
3. **Grandfathering Provision:** Properties acquired on or before March 27, 2021, are subject to a transitional rule allowing interest deductibility to be phased out gradually until March 31, 2025, after which it will no longer be deductible.

Date interest incurred	Percentage of interest that can be claimed
1 April 2020 to 31 March 2021	100%
1 April 2021 to 30 September 2021	100%
1 October 2021 to 31 March 2022	75%
1 April 2022 to 31 March 2023	75%
1 April 2023 to 31 March 2024	50%
1 April 2024 to 31 March 2025	25%
On or after 1 April 2025	0%

4. **New Property Acquisitions:** For properties acquired after March 27, 2021, the ability to deduct interest expenses is more restricted.
5. **Exceptions:** Certain types of property, such as new builds, are exempt from these changes and retain interest deductibility to encourage new housing supply.

The National Party in New Zealand has proposed changes to the interest deductibility law for rental properties. Here are the key aspects of their proposal:

1. **Reinstatement of Tax Deductibility**: The National Party plans to reinstate the tax deductibility of interest on rental properties. This change is part of their broader strategy to contain inflation and support economic growth.

2. **Phased Implementation:** The plan includes restoring mortgage interest deductibility for rental properties progressively, with a 60% deduction in 2023/24, increasing to 80% in 2024/25, and fully restoring 100% deductibility by 2025/26.
3. **Impact on Property Market:** These changes are intended to alleviate the financial pressures on rental property owners, particularly in light of rising interest rates and other increasing costs such as compliance with healthy homes standards.

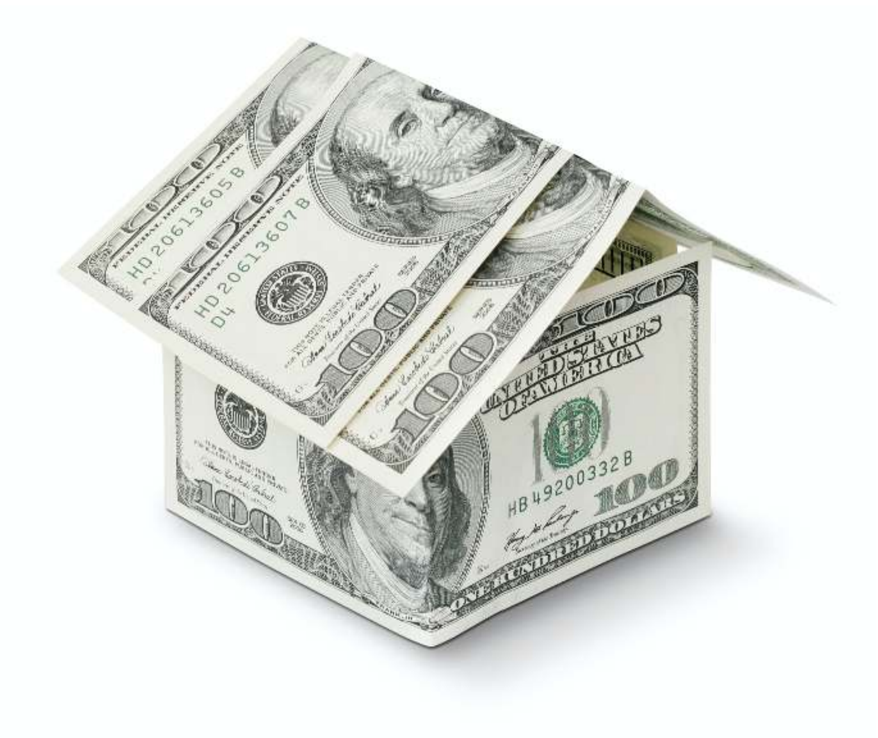
5. **Policy Critique:** The removal of interest deductibility under the Labour government was seen by some as punitive to landlords and not necessarily effective in improving housing affordability. Critics argued that it put upward pressure on rents and could potentially reduce the supply of new housing developments.

6. **Broader Tax Reforms:** Alongside reinstating interest deductions, the National Party also plans to reduce the applicable period of the Brightline test from 10 years back to two years. The Brightline test requires property owners to pay income tax on properties sold within a certain timeframe.

6. **Encouragement for New Builds:** The current law under the Labour government did not completely remove interest deductibility but rather encouraged investment in new builds to help ease the housing crisis.

7. **Economic and Housing Policy:** These changes are part of a broader approach by the National Party to address economic issues, including labour shortages, business investment, and housing market regulation.
8. **Debate on Housing Solutions:** The proposed policy has sparked debate between various stakeholders, including property investors, renter advocacy groups, and economic experts, on the best approach to manage the housing market and support economic growth.

The National Party's proposed changes to the interest deductibility law for rental properties in New Zealand aim to restore tax deductions for mortgage interest, reduce the Brightline test period, and address wider economic and housing market issues. However, these proposals have been met with mixed reactions, reflecting the complexity of balancing housing affordability, investor incentives, and overall economic health.



2. Capital Gains and the Brightline Test

The Bright-line test in New Zealand is a significant aspect of the country's approach to capital gains tax on residential property. This test determines under what conditions the gain from selling a residential property is subject to income tax. Here's an overview of the current state of the Bright-line test and the proposals from the National Party:

Current Brightline Test

- **Duration:** As of April 2021, the Bright-line test applies to properties sold within 10 years of purchase, meaning any capital gains on these properties are subject to income tax.
- **Exemptions:** The family home (main residence) is generally exempt from this test. Additionally, there are exceptions for inherited properties and those transferred as part of a relationship property settlement.
- **Purpose**: The extension of the Bright-line test from 2 years (introduced in 2015) to 5 years (in 2018) and then to 10 years was aimed at reducing speculative behaviour in the housing market and cooling property price inflation.
- **Tax Rate:** The tax rate applied to the gain is based on the seller's marginal income tax rate.

National Party's Proposal

- **Reduction of Duration:** The National Party proposes to roll back the duration of the Bright-line test from 10 years to 2 years. This change implies that only the gains from properties sold within two years of purchase would be subject to income tax.
- **Rationale:** The rationale behind this proposal is to stimulate investment in the housing market and reduce the tax burden on property investors.
- **Housing Market Impact:** This reduction is seen as a way to encourage more people to invest in the housing market, possibly increasing the supply of rental properties and impacting overall housing affordability.

Further Discussion

- **Housing Affordability:** The Bright-line test was initially extended to address housing affordability issues by discouraging quick resale for profit. However, its effectiveness in achieving this goal has been a subject of debate.
- **Investment Incentives**: Reducing the Bright-line test period could make property investment more attractive by lowering potential tax liabilities on short-term property investments.
- **Market Dynamics:** The proposal by the National Party might shift market dynamics, potentially increasing short-term property trading and affecting the housing market's overall stability.
- **Tax Revenue and Government Policy:** The current 10-year rule likely increases tax revenue from property sales and aligns with broader government efforts to cool an overheated housing market. The proposed reduction could lead to a decrease in such revenues but might be aligned with the National Party's broader economic policies.
- **Balancing Act:**This issue illustrates the balancing act between encouraging property investment, ensuring tax fairness, and addressing the broader social issue of housing affordability.

The Brightline test in New Zealand is a key tool in the country's approach to taxing capital gains on residential properties, with current regulations imposing a 10-year window. The National Party's proposal to reduce this period to 2 years represents a significant shift, aimed at stimulating property investment but also raising questions about the potential impact on housing affordability and market stability.

3. Income Tax on Rental Income

Income tax on rental income is a critical aspect for residential property investors in New Zealand. Here's an expanded overview:

1. **Taxable Income:** Rental income from properties owned in New Zealand is considered taxable income. This includes not just the regular rent payments, but also any additional fees tenants pay, such as for late rent, maintenance, or service charges.
2. **Calculating Taxable Income:** To determine the taxable income, investors must deduct allowable expenses from their total rental income. Allowable expenses can include mortgage interest payments (subject to recent changes regarding interest deductibility), property maintenance and repairs, property management fees, insurance, rates, and depreciation on certain items.
3. **Declaring Rental Income:** Property investors are required to declare their rental income to the Inland Revenue Department (IRD) through an income tax return. This needs to be done annually.
4. **Tax Rates:** The tax rate applied to rental income is the same as the investor's personal income tax rate. In New Zealand, personal income tax rates are progressive, meaning the rate increases as the individual's income increases.
5. **Record Keeping:** Accurate and detailed record-keeping is essential. Investors must keep records of all rental income received and expenses incurred for at least seven years. These records are necessary for tax purposes and in case of an audit by the IRD.

6. **Loss Ring-Fencing Rules:** Since the 2019/2020 tax year, residential property investors can no longer offset losses from their rental properties against other income (like salary or business income). Instead, these losses are 'ring-fenced' and can only be used to offset future rental income or any gain on the sale of rental properties.
7. **Invoicing and Receipts:** Providing tenants with receipts for rent paid is good practice and aids in maintaining clear financial records.
8. **GST (Goods and Services Tax):** Generally, residential rental income is exempt from GST. Therefore, residential landlords typically do not charge GST on rent and cannot claim GST on their expenses.
9. **Changes in Ownership or Property Use:** If there are changes in the ownership of the property or its use (for example, converting it from a rental property to a personal residence), this can have implications for income tax.
10. **Foreign Property Investors:** The National Party have announced changes to the tax law on foreign buyers. The current foreign buyer ban would remain for houses worth under $2m, while houses above that price would attract a 15% foreign buyer tax for anyone without a resident-class visa. Sensitive land tests would still apply, and the tax would be charged at point of sale.

Understanding and correctly managing income tax obligations on rental income is crucial for residential property investors in New Zealand. Mismanagement or misunderstanding of these obligations can lead to penalties and added costs. Therefore, many investors opt to work with accountants or tax advisors who are familiar with property investment taxation.

4. Claiming Expenses

Property investment in New Zealand is a popular avenue for wealth creation. However, the profitability of such investments is significantly influenced by the investor's ability to manage expenses effectively. Understanding these expenses is crucial for effective financial management and tax planning, ensuring compliance with the Inland Revenue Department (IRD) regulations while maximising profitability. In New Zealand, several types of expenses related to rental properties are deductible. These include:

1. **Mortgage Interest:** Interest payments on loans taken out to purchase a rental property are deductible. See above for limitations on this deduction and propose changes to be brought in by the National Party.
2. **Insurance:** Premiums paid for insuring the rental property can be claimed. This includes building, contents, and liability insurance.
3. **Property Rates:** Local council rates, which are a charge against the property, are deductible.
4. **Property Management Fees:** If a property manager is used, their fees, including commissions, are deductible.
5. **Repairs and Maintenance:** Costs incurred in repairing and maintaining the property are deductible. However, there's a distinction between repairs/maintenance and improvements – the latter not being immediately deductible.
6. **Utility Expenses:** If the landlord pays for utilities (like water), these costs can be deducted.
7. **Depreciation:** Certain assets' depreciation, like chattels, can be claimed. The rules around this have undergone changes, so specific advice is required.
8. **Legal and Accounting Fees:** Professional fees directly related to the operation of the rental property are deductible.
9. **Travel Expenses:** Costs incurred while traveling to inspect or maintain the property can be claimed. This includes a portion of vehicle expenses.
10. **Advertising:** Costs for advertising the property for rent are deductible.

By understanding and strategically managing deductible expenses, investors can optimise their tax position. This involves not just claiming all allowable expenses but also understanding the timing and nature of these expenditures. Staying informed of the evolving tax landscape and seeking professional advice when necessary is paramount in ensuring compliance and optimising returns.

5. Depreciation

Depreciation is the accounting process of allocating the cost of tangible assets over their useful lives. In New Zealand, the rules around property depreciation for residential property investors have undergone changes in recent years, impacting how investors can claim depreciation on qualifying assets. For residential property investors, this can apply to various assets associated with their rental properties. Understanding these rules is crucial for property investors to accurately calculate their taxable income and maximise their tax efficiency.

1. Depreciation on Residential Properties

- **Application:** Depreciation for residential properties primarily applies to the building's fit-out (like chattels, appliances, and furnishings) rather than the building structure itself. The structure of residential buildings is generally non-depreciable, except in very limited circumstances (e.g., certain multi-unit properties).
- **Depreciation Rates:**The rates of depreciation are set by the Inland Revenue Department (IRD) and vary depending on the asset's class and expected lifespan.

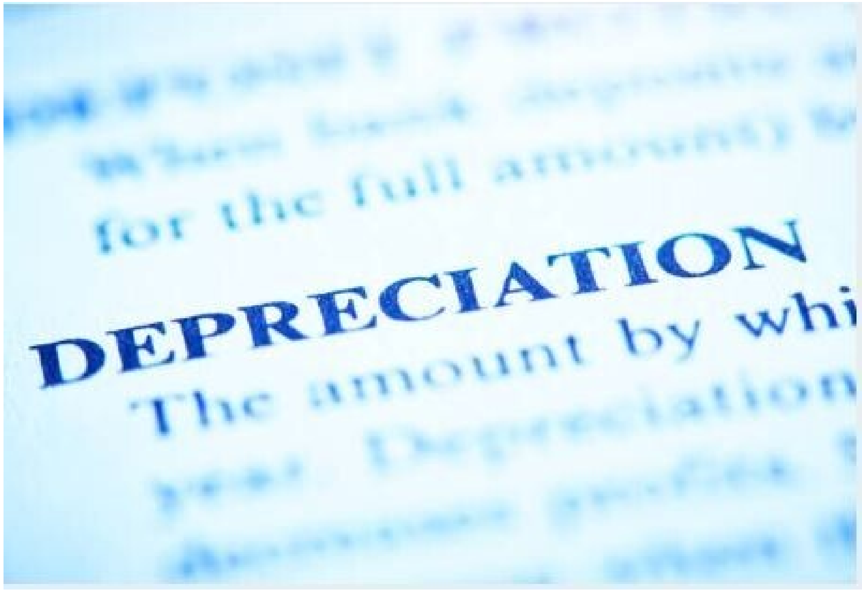
2. Current Considerations

- Tax Deductions: Residential property investors can claim depreciation on qualifying assets as a tax deduction against their rental income. This helps reduce their overall taxable income.
- **Ring-Fencing Rules:** The residential property deduction rules, also known as the ring-fencing rules, allow property owners to claim deductions up to the amount of rental income earned in a year, including income from the sale of a property.

3. Implications for Property Investors

- **Strategic Asset Management:** Investors need to strategically manage their assets, considering the depreciation benefits of fit-out versus structural elements.
- **Compliance:** Investors must ensure compliance with the current IRD regulations regarding depreciation and maintain accurate records for tax purposes.
- **Professional Advice:** Given the complexities and potential changes in tax law, it is advisable for property investors to seek professional tax advice to fully understand the implications of these rules on their investments.

While the ability to claim depreciation on residential rental properties was reinstated in 2020 in New Zealand, it primarily applies to the building's fit-out. The potential changes proposed by the National Party underline the dynamic nature of tax laws, emphasizing the need for investors to stay informed and seek professional guidance.



6. Healthy Homes

The Healthy Homes Standards in New Zealand, which became law on 1 July 2019, set specific and minimum standards for rental properties in terms of heating, insulation, ventilation, moisture ingress and drainage, and draught stopping. These standards are aimed at improving the quality of rental homes, thus enhancing the health and safety of tenants, while also reducing maintenance costs for landlords.

1. Compliance Timeframes

- **Private Rentals:**Between 1 July 2021, and 1 July 2025, all private rentals must comply with the standards within specific timeframes, depending on when a new tenancy starts or is renewed.
- **Boarding Houses:** All boarding houses were required to comply by 1 July 2021.
- **Kainga Ora and Community Housing Providers:** Must comply by 1 July 2024

2. Heating

- **Fixed Heaters:** Landlords must provide fixed heaters in the main living room, capable of achieving a minimum indoor temperature of 18°C.
- **Heater Types:** Acceptable heaters include heat pumps, wood burners, pellet burners, or flued gas heaters. Unacceptable types are open fires and unflued combustion heaters.
- **Heating Capacity:** Heaters must have at least 1.5 kW capacity. Landlords can use tools, formulas, or professional assessments to determine the required heating capacity.
- **Central Heating:** Must directly heat the main living room and meet the required heating capacity.

3. Insulation

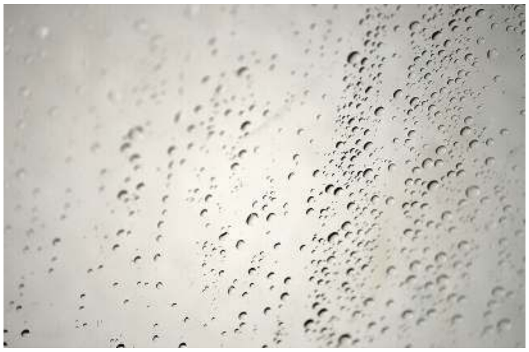
- **R-Value Standards:** The required R-value for insulation varies based on climate zones in New Zealand, with specific R-values for ceiling and underfloor insulation.
- **Insulation Condition:** Must be free of mold, dampness, or damage. Ceiling insulation installed before July 1, 2016, must be at least 120mm thick.
- **Exemptions:** Include inaccessible or unsafe areas, partial exemption for certain underfloor insulation, and areas with habitable spaces directly above or below.

4. **Ventilation**

- **Openable Windows:** Required in all habitable rooms, with the total openable area being at least 5% of the floor area.
- **Extractor Fans:** Mandatory in kitchens and bathrooms. Kitchen fans or rangehoods installed after July 1, 2019, must have a minimum diameter of 150mm or an exhaust capacity of 50 litres per second. Bathroom fans must have a minimum diameter of 120mm or an exhaust capacity of 25 litres per second.
- **Continuous Mechanical Ventilation Systems:** An alternative to extractor fans, these systems must vent extracted air outdoors and meet specific installation and performance criteria.

5. **Moisture Ingress and Drainage**

- **Drainage Systems:** Must efficiently remove stormwater, surface water, and groundwater. This includes gutters, downpipes, and drains for roof water.
- **Ground Moisture Barrier:** Required for properties with enclosed subfloors, where practicable. These barriers, typically polythene sheets, must be installed according to specific standards.



The Healthy Homes Standards aim to address issues related to cold, damp, drainage, and draughts in rental properties. Approximately 600,000 households rent in New Zealand, and research indicates that rental properties are generally of poorer quality than owner-occupied homes. By enhancing the quality of these rental homes, New Zealanders who rent will likely experience improved health, lower medical costs, fewer hospitalizations, and properties will be less prone to issues like mold and mildew, thus safeguarding the landlord's investment.

7. Building Code Compliance

Compliance with the New Zealand Building Code is a critical aspect for residential property investors, as it ensures that properties are safe, healthy, and durable for occupation. The Building Code sets out performance standards that all building work in New Zealand must comply with. It has also undergone several updates as of 2023, which are essential for residential property investors to understand and comply with. These updates ensure that buildings are safe, healthy, and durable, aligning with modern construction methods, products, and technologies.

Recent Updates to the New Zealand Building Code

1. **Plumbing and Drainage:**

- Amendments to the acceptable solutions and verification methods for Surface Water (E1), Water Supplies (G12), and Foul Water (G13) were introduced.
- Key changes include updating the limits for lead in plumbing products, reducing hot water temperatures for personal hygiene from 55°C to 50°C, and improving backflow contamination protection.
- The adoption of the latest AS/NZS 3500 plumbing and drainage standards, which include several New Zealand-specific requirements, is a significant part of these amendments.

2. **Fire Safety:**

- Acceptable Solutions and Verification Methods related to fire safety (C/AS1, C/AS2, F7/AS1, and C/VM2) were amended to improve the safety of people from fire and align requirements with the latest industry standards.
- The introduction of interconnected smoke alarms in residential units and new standards for sprinkler systems, fire alarm systems, and smoke control in air-handling systems are part of these changes.

3. Energy Efficiency:

- The energy efficiency requirements for windows and doors in new residential buildings have been increased.
- By November 2023, windows in new houses must meet the new increased performance levels, requiring a gas between the glass (not just air) and more thermally insulating glass than normal window glass.

4. Structural Stability:

Modifications were made regarding the structural stability of hollow-core floors, affecting the citation of NZ Standard NZS 3101.1: 2006 within B1/VM1.

Implications for Property Investors

1. **Building and Renovation Costs:** These changes, especially in energy efficiency and fire safety, may increase the costs of building and renovating properties.
2. **Compliance and Consent:** Investors must ensure that any new building work or significant renovations comply with these updated standards. Building consents may be required for substantial changes.
3. **Health and Safety:** The amendments focus on enhancing the safety and wellbeing of occupants, which is a key responsibility for property investors.
4. **Transition Periods:** Most of these changes have a transition period of 12 months, ending on 1 November 2024. This provides a window for investors and builders to adjust to the new requirements.

The 2023 updates to the New Zealand Building Code reflect the government's commitment to safety, health, and sustainability in building practices. Residential property investors need to be aware of these changes to ensure compliance, enhance the value and safety of their properties, and avoid potential legal and financial penalties.

For more information and to schedule a no obligation meeting at no cost to you, please contact the author on 021 041 0667 or at dapfel@frsoutsourcing.com