Interpretation Statement as the ring-fencing rules). Therefore, the explanation of the deductibility of interest in this item supersedes the explanations of the deductibility of interest in those earlier items.

Structure of this Interpretation Statement

6. This Interpretation Statement is structured so that you only need to read the parts that are relevant to your circumstances. First there is an overview of the interest limitation rules, and then the Interpretation Statement is broken up into sections that explain how the interest limitation rules, and other relevant tax rules, apply to each of the short-stay accommodation situations specified in [1]. An appendix provides additional detail on some aspects of the interest limitation rules and the other relevant tax rules that may apply.
7. The Interpretation Statement and appendix cross-reference one another to assist you to locate the information relevant to your situation (without the need to read the entire item, as some content may not be relevant to your situation). For example, if your short-stay dwelling is a separate dwelling on the same land as your main home, we suggest you read the relevant section in the Interpretation Statement and then, if you need to, read the relevant cross-referenced content in the appendix that provides additional detail.
8. First, however, we suggest you read the overview of the interest limitation rules in [9] to [22].

Analysis | Tātari

Overview of the interest limitation rules applying to short-stay dwellings

9. The interest limitation rules in subpart DH apply to interest incurred on or after 1 October 2021 to the extent it is for disallowed residential property (DRP). The rules:
   - Deny all interest deductions for DRP acquired on or after 27 March 2021.
   - Progressively deny deductions for grandparented residential interest, which is interest incurred for DRP acquired before 27 March 2021 with a loan drawn down before that date or a loan that refinances such a loan (a grandparented transitional loan). A portion of grandparented residential interest is allowed during the phase-out period (1 October 2021 to 31 March 2025) and from 1 April 2025 interest deductions will be fully denied.

Figure | Hoahoa 4 – Short-stay accommodation provided in a separate dwelling on the same land as your main home – one loan and the short-stay dwelling is not new build land – overview of rules relevant to interest deductibility

Interest limitation rules	Apportionment rules	Ring-fencing rules
Apportion the loan interest between your main home and the short-stay dwelling. The interest limitation rules apply to the interest apportioned to the short-stay dwelling. Interest deductions for the interest apportioned to the short-stay dwelling are not allowed – subject to partial deductibility in the phase-out period[27] if you have a grandparented transitional loan.[28]	If there is private use of the short-stay dwelling and: • you can deduct a portion of the interest in the phase-out period because you have a grandparented transitional loan: • the sale of the property could be taxed apportion the interest under either the MuA rules or standard deductibility rules (see from [101]). The interest limitation rules override the ability to deduct interest under the MuA rules or standard deductibility rules. But performing the apportionment will calculate the interest that would have been deductible but is denied by the interest limitation rules. Keep track of denied interest deductions if the sale of the property could be taxed (eg, under the bright-line test), as denied interest may become deductible in the future.	The ring-fencing rules are unlikely to apply to limit your total deduction for the income year, but they will if: • you have not used more than 50% of the land for your main home, • the MuA rules do not apply to the short-stay dwelling, and • the rental activity for the short-stay dwelling[29] is loss-making.

95. If you have one loan for both your main home and your separate short-stay dwelling, you will need to determine how much of the interest incurred in the income year is for your short-stay dwelling and how much is for your main home. This is called "apportionment". It is discussed in the appendix from [A17].

96. Apportionment is necessary because the interest limitation rules:

- Apply to the interest apportioned to your short-stay dwelling.

[27] The phase-out period is 1 October 2021 to 31 March 2025.

[28] A grandparented transitional loan is a loan drawn down before 27 March 2021 or a loan that refinances such a loan.

[29] Or a portfolio of rental properties if you have one.

Appendix: Additional detail on some aspects of the interest limitation rules and the other rules that may apply

A1. As noted at [6] in the Interpretation Statement, this appendix provides additional detail on some aspects of the interest limitation rules and the other relevant tax rules that may apply, depending on your circumstances. This appendix provides additional detail on:

- The definition of "disallowed residential property" – see from [A2].
- The definition of "excepted residential land" – see from [A6].
- The new build land exemption from the interest limitation rules – see from [A8].
- "To the extent to which" (apportionment) – see from [A17].
- Grandparented transitional loans and grandparented residential interest – see from [A22].
- Grandparented transitional loans that cannot reasonably be traced – see from [A28].
- Grandparented transitional loans and the high water mark rule – see from [A39].
- The ring-fencing rules – see from [A48].
- Situations where the future disposal of a property with someone's main home and a short-stay dwelling on it might be taxable – see from [A66].

Definition of "disallowed residential property"

A2. Key terms used in the interest limitation rules are defined in s DH 5.

A3. The key term "disallowed residential property" (DRP) is defined in s DH 5(2):

DH 5 Key terms

…

Disallowed residential property

(2) Disallowed residential property—

(a) means land in New Zealand to the extent to which—

(i) it has a place configured as a residence or abode, whether or not it is used as a place of residence or abode, including any appurtenances belonging to or enjoyed with the place:

(ii) the owner has an arrangement that relates to erecting a place there, configured as a residence or abode, whether or not that place is or is to be used as a place of residence or abode, including any appurtenances belonging to or enjoyed with the place:

(iii) it is bare land that, under rules in the relevant operative district plan, may be used for erecting a place there, configured as a residence or abode, whether or not that place is or is to be used as a place of residence or abode, including any appurtenances belonging to or enjoyed with the place:

(b) does not include land to the extent to which it is excepted residential land.

A4. Relevantly (in the context of short-stay accommodation), DRP is land in New Zealand to the extent to which it has a place configured as a residence or abode, and it includes any appurtenances belonging to or enjoyed with the place. It does not matter whether the place is used as a residence or abode.

A5. Land with a short-stay dwelling on it is DRP because it is land that has a place (the dwelling) configured as a residence or abode. The interest limitation rules will apply to interest incurred for the short-stay dwelling unless:

- the short-stay dwelling is on land that is excepted residential land (for example, farmland), or
- the new build land exemption applies.

Definition of "excepted residential land"

A6. The key term "excepted residential land" is defined in s DH 5(3) and means land to the extent to which it is described in sch 15.

A7. Schedule 15 states:

Schedule 15

Excepted residential land

1. Business premises, except if the business premises—
   (a) are used or available for use in a business of supplying accommodation; and
   (b) are not land described in clause 7.
2. Farmland, including any place configured as a residence or abode, whether or not it is used as a place of residence or abode, including any appurtenances belonging to or enjoyed with the place.
3. A hospital, convalescent home, nursing home, or hospice.
4. A boarding establishment.
5. A hotel, motel, inn, hostel, or camping ground.
6. A rest home or retirement village.
7. For the relevant person (person A), land that has been used predominantly for a place configured as a residence or abode, including any appurtenances belonging to or enjoyed with the place, if that place is the main home for 1 or more of the following people:
   (a) person A;
   (b) a beneficiary of a trust, if person A is a trustee of the trust and—
      (i) a principal settlor of the trust does not have a main home; or
      (ii) if a principal settlor of the trust does have a main home, the place is their main home.
8. Student accommodation.
9. For the relevant person, employee accommodation.
10. Māori excepted land.

New build land exemption from the interest limitation rules

A8. Section DH 4 contains exemptions from the interest limitation rules, including the new build land exemption.

A9. The new build land exemption provides that the interest limitation rules do not apply to interest incurred by a person to the extent to which it is incurred in relation to new build land and in a 20-year period starting from a specified date.[72]

A10. The exemption applies to every owner of the new build land during the 20-year exemption period.

A11. The phrase "to the extent to which" recognises that in some cases only part of a single parcel of land will be new build land and that apportionment will be required. Apportionment is discussed from [A17].

A12. The term "new build land" is defined in s DH 5(7).

A13. The following sets out the types of new build land and the date the 20-year exemption period starts for each:

- Land to the extent to which it has a place that is configured as a self-contained residence or abode, if a code compliance certificate has been issued on or after 27 March 2020 evidencing that the place was added to the land or converted into a residence or abode. This includes land exclusively used by residents of the place and also a reasonable portion of shared areas of land, appurtenant to the place. In this case, the 20-year exemption period starts on the date on which the code compliance certificate is issued.
- Land for which there is an agreement that a place that is configured as a self-contained residence or abode will be added to the land and a code compliance certificate will be issued on or after 27 March 2020 evidencing that the place was added to the land. In this case, the 20-year exemption period starts on the date on which the code compliance certificate is issued.
- Land that has a place that was a hotel or motel, to the extent to which, by a conversion, it becomes places that are configured as self-contained residences or abodes, and the conversion is recorded in the records of a local authority or building consent authority as having been "completed" on or after 27 March 2020. In this case, the 20-year exemption period starts on the date that, in the records of the local authority or building consent authority, the conversion is recorded as having been completed.
- Land to the extent to which it has a place that is configured as a self-contained residence or abode, if the place was removed from the earthquake prone buildings register on or after 27 March 2020, and—
  - a code compliance certificate has been issued on or after 27 March 2020 evidencing that building work to remediate the place is complete:

[72] Section DH 4(1).

- the completion of the building work to remediate the place is recorded in the records of a local authority or building consent authority as having been "completed" on or after 27 March 2020 and as having been verified by a suitably qualified engineer.

In this case, the 20-year exemption period starts either on the date on which the code compliance certificate is issued or on the date that, in the records of the local authority or building consent authority, the remediation is recorded as having been completed (as applicable).

- Land to the extent to which it has a place that is configured as a self-contained residence or abode, if the place was not previously weather-tight and a code compliance certificate has been issued on or after 27 March 2020 evidencing that at least 75% of the place's cladding has been replaced. In this case, the 20-year exemption period starts on the date on which the code compliance certificate is issued.

A14. However, in the case of a code compliance certificate issued subject to a building consent waiver or modification under clause B2.3.1 of the Building Code under the Building Act 2004, the 20-year exemption period starts from the date the relevant building work is entered into the records of the local authority or building consent authority as "substantially completed".

New build must be a self-contained residence or abode

A15. The definition of new build land requires that the new place (or converted place) is a "self-contained residence or abode". This phrase is not defined in the Act. However, its ordinary and plain meaning requires that a place has the necessary facilities, such as a kitchen, bathroom, toilet, and electricity, to enable it to be used as a residence or abode. A dwelling will not be self-contained if it uses essential facilities that are shared with another dwelling (for example, the main home). A sleepout used to provide short-stay accommodation will not be new build land if it is not self-contained.

A16. Although the interest limitation rules will not apply to your short-stay dwelling to the extent to which it is new build land, the ring-fencing rules may apply. The ring-fencing rules are discussed from [A48].

"To the extent to which" (apportionment)

A17. The phrase "to the extent to which" is used in the Act to indicate that apportionment may be required, depending on the facts.

A18. The phrase is used in various parts of the interest limitation rules. For interest incurred for a dwelling used to provide short-stay accommodation, the phrase is used in the following relevant ways:

- DRP is defined as land in New Zealand "to the extent to which" it has a place (dwelling) configured as residence or abode, including any appurtenances belonging or enjoyed with that place.
- The new build land exemption provides that the interest limitation rules do not apply to interest incurred by a person "to the extent to which" it is incurred for new build land.
- Land is excluded from definition of DRP "to the extent to which" it is excepted residential land.
- Excepted residential land is defined as land "to the extent to which" it is described in sch 15.

A19. The interest limitation rules do not specify the apportionment method that is to be used and therefore the existing principles from case law apply. These principles provide that the onus is on the taxpayer to establish that their preferred method is the one that should be adopted and that it achieves the objective of a fair and reasonable assessment. Whether a particular method is fair and reasonable depends on the facts and circumstances of each case.

A20. To illustrate:

- DRP is land to the extent to which it has a place configured as a residence or abode. However, DRP does not include land to the extent to which it is excepted residential land. Business premises are excepted residential land, unless it is a business of supplying accommodation in a dwelling that is not the person's main home.[73]
- If your business premises (for example, a retail shop) and your short-stay dwelling are on the same land (record of title) and you incur interest for the land, you will be required to apportion the land to determine the proportion of the land that is the business premises and the proportion that is the short-stay dwelling. The interest limitation rules will apply only to the interest apportioned to the short stay-dwelling (unless an exemption such as the new build land exemption applies).
- A percentage of total land area apportionment method is likely to be appropriate. Under this method, if the land area of your short-stay dwelling (including appurtenances) is 60% of the total land area, then 60% of the interest

[73] Or the main home of a beneficiary of a trust, if the owner of the property is a trustee, provided no principal settlor of the trust has a different main home.

you incur for the land is apportioned to your short-stay dwelling and subject to the interest limitation rules.

A21. In other circumstances, a different apportionment approach might be appropriate to achieve the objective of a fair and reasonable assessment – for example, apportionment based on valuation of different parts of the land.

Grandparented transitional loans and grandparented residential interest

A22. If your short-stay dwelling is DRP and you acquired the dwelling before 27 March 2021 with a grandparented transitional loan, your deductions for grandparented residential interest (that is, interest incurred on the principal of a grandparented transitional loan) are progressively denied in the transitional period from 1 October 2021 to 31 March 2025. From 1 April 2025, you will not be allowed any deductions for interest.

A23. A grandparented transitional loan is a New Zealand denominated loan for DRP first drawn down:

- Before 27 March 2021.
- On or after 27 March 2021, if an estate or interest in the DRP was acquired before 27 March 2021 (for example, under a binding agreement for sale and purchase).
- On or after 27 March 2021, if the acquisition of the DRP resulted from an offer made on or before 23 March 2021 that could not be revoked by the purchaser before 27 March 2021.
- On or after 27 March 2021, if the following three requirements are satisfied:
  - A previous owner of the DRP (the original owner) had a loan under one of the three preceding bullet points.
  - A bright-line rollover provision applies to every transfer of the DRP from the original owner to any intermediate owner to the current owner (the taxpayer).
  - The taxpayer's loan amounts are equal to or less than the amount of the original owner's loan at the time the original owner transferred the DRP.

A24. A grandparented transitional loan does not include any re-drawings or additional borrowings under the same loan facility on or after 27 March 2021.

A25. If you have a grandparented transitional loan for your short-stay dwelling (and the dwelling is DRP) and you take out a new loan to refinance that loan, the new loan will be treated as a grandparented transitional loan. The interest you incur on the new

loan, to the extent to which it is for the short-stay dwelling, will be progressively denied from 1 October 2021 to 31 March 2025.

A26. The percentages of the deduction for grandparented residential interest progressively denied in the transitional period are:

Figure | Hoahoa 11 – Transitional period interest denial percentages

Period that grandparented residential interest is incurred	Percentage denied
1 October 2021 to 31 March 2022	25%
1 October 2022 to 31 March 2023	25%
1 October 2023 to 31 March 2024	50%
1 October 2024 to 31 March 2025	75%
On and after 1 April 2025	100%

A27. If you have an amount of grandparented residential interest for your short-stay dwelling, you will need to consider whether the ring-fencing rules apply to limit the amount of your deduction.

Grandparented transitional loan that cannot reasonably be traced

A28. The tracing approach is generally used to identify whether interest you incur is for DRP.

A29. In some rare cases, you may have used a grandparented transitional loan to purchase both a short-stay dwelling (that is DRP) and other property that you use to derive income (for example, a commercial building) and the portion of the loan used for the dwelling cannot be reasonably determined (an untraceable loan). In this situation, a special rule applies to treat a portion of the untraceable loan (the notional loan principal) as having been used to purchase the dwelling. Interest on the notional loan principal is treated as grandparented residential interest, and deductibility of that interest is progressively denied over the transitional period from 1 October 2021 to 31 March 2025. Interest on the remaining portion of the grandparented transitional loan is not subject to the interest limitation rules, and deductibility of that interest is determined under the general (or other applicable) deduction rules.

A30. The special rule only applies when the portion of a grandparented transitional loan used for DRP "cannot reasonably be determined". This will be a question of fact and degree in each case. You must answer this question objectively. This means you determine whether a reasonable person could not, in the circumstances of the case,

reasonably determine the portion of the loan that was used for DRP. Whether the necessary information to calculate the portion is available, or can be reasonably obtained, is likely to be a highly relevant factor for the "cannot reasonably be determined" question. If information needs to be obtained from a third party (such as a bank, accountant, or lawyer) and they charge for the information, this would not in itself mean the portion of the loan used for DRP cannot reasonably be determined.

A31. If you have an untraceable loan, you need to apply the following formula to determine the notional loan principal of the loan:

outstanding borrowings – allowed property

A32. In the formula:

- Outstanding borrowings is the amount of the untraceable loan on 26 March 2021 (excluding any amount not used for either DRP or allowed property).
- Allowed property is the total value of your property on 26 March 2021, excluding DRP and ignoring property not used to derive assessable income. However, the value of DRP held on 26 March 2021 to which an exemption applies (for example, the new build exemption) is included in allowed property.

A33. You must apply the following valuation rules to determine the value of your allowed property:

- For land, including new build land but excluding land acquired for a s CB 7 business relating to land and land subject to an undertaking or scheme involving development, division or building to create new build land:
  - the most recent capital value or annual value set by a local authority, or
  - if the land was acquired after the most recent local authority valuation, its acquisition cost or, if acquired from an associated person, its market value.
- For all other property, its tax book value or, if you prepare financial accounts according to relevant accounting standards or legislative standards, the financial accounts' valuation.

A34. If the result of the formula is positive, interest on the positive amount is grandparented residential interest and is progressively denied over the transitional period from 1 October 2021 to 31 March 2025. If the result is negative, it is treated as zero and no amount of interest is treated as grandparented residential interest.

A35. The formula, in effect, treats an untraceable loan as being used to acquire allowed property before acquiring DRP. If the value of your allowed property on 26 March 2021 exceeds the value of your outstanding borrowings on 26 March 2021, none of the

interest on the outstanding borrowings will be subject to denial under the interest limitation rules.

A36. If you have an untraceable loan, for tax purposes you will in effect be treated as having two loans – the notional loan principal (treated as being used for DRP) and a remaining loan (treated as being used for allowed property). When you make a repayment reducing the balance of the untraceable loan, you need to apply special repayment rules to allocate the repayment to the reduction of either the notional loan principal or the loan for allowed property.

A37. The general repayment rule is that repayments are applied first against the notional loan principal. When the notional loan principal is reduced to zero, there will be no grandparented residential interest, and the interest limitation rules will no longer apply to the untraceable loan.

A38. The general rule is overridden when the source of the repayment is the disposal of allowed property that you owned on 26 March 2021. In this situation, only the amount (if any) of the repayment that exceeds the 26 March 2021 value of that allowed property is applied in reduction of the notional loan principal. If the repayment is less than or equal to the 26 March 2021 value of the disposed of item of allowed property, the repayment does not reduce the notional loan principal.

Grandparented transitional loan and the high water mark rule

A39. If your grandparented transitional loan for your short-stay dwelling is a variable balance loan (a grandparented transitional variable balance loan), such as a revolving credit facility or an overdraft, you can choose whether to apply the high water mark rule to simplify the calculation of your grandparented residential interest.

A40. The high water mark rule simplifies the calculation of grandparented residential interest for a grandparented transitional variable balance loan by making it unnecessary to trace each individual withdrawal and deposit to that loan between 27 March 2021 and 30 March 2025. Under the high water mark rule, the period from 1 October 2021 to 31 March 2025 is referred to as the affected interest period. Simplification is optimised if a grandparented transitional variable balance loan has only been used for DRP and the balance at any "instant" during the affected interest period does not exceed the initial loan balance.

A41. Under the high water mark rule:

- For a period in the affected interest period the amount of interest that is treated as grandparented residential interest is the total amount of interest for all "instants" in the "period" that are for, or traced to, DRP.

subject to progressive denial from 1 October to 2021 to 31 March 2025 at the percentages for the periods set out in the table at [A26].

Ring-fencing rules

A48. Although the interest limitation rules do not apply to interest you incur for a short-stay dwelling that is new build land, you will need to determine whether the ring-fencing rules apply in an income year to limit the deduction you can claim for the interest (and other expenditure) you incur for the new build land.

A49. The ring-fencing rules may also be relevant to land that is not new build land, but it is likely this would only be the case:

- during the phase-out period, or
- if the property is part of a portfolio for which interest is deductible.

A50. This is because the ring-fencing rules only limit the deduction allocated to the income year if the rental activity of the property or portfolio is loss-making – which it is not likely to be if interest is not deductible.

A51. The ring-fencing rules[75] apply to "residential rental property" which is "residential land for which a person who owns the land is allowed a deduction relating to the use or disposal of the land". The definition of "residential land" includes land that has a dwelling on it unless the land is farmland or is used predominantly as business premises. It also includes land that has a dwelling on it if the land is used by a person predominantly as a business premises for business of supplying accommodation and the dwelling is not the person's main home.[76]

A52. The ring-fencing rules apply in each income year a person is allowed a deduction for expenditure or loss incurred in relation to a residential rental property or a portfolio of residential rental properties. The default position under the rules is that they apply on a residential portfolio basis. A residential portfolio is one or more residential rental properties that a person holds in a portfolio. However, a person can elect to apply the ring-fencing rules on a property-by-property basis.

A53. The ring-fencing rules do not apply to residential land owned by a person for an income year if more than 50% of the land is used for most of the income year as a main home. The rules also do not apply to residential land to which the mixed-use

[75] A comprehensive explanation of the ring-fencing rules can be found in *Tax Information Bulletin* Vol 31, No 8 (September 2019): 53.

[76] Or the main home of one or more other persons referred to in s CB 16A(2).

forward to a later income year in which the person derives residential income from another residential rental property and is transferred to that property.

Situations where the future disposal of a property with someone's main home and a short-stay dwelling on it might be taxable

A66. If your interest deductions are denied (or partly denied) by the interest limitation rules, then you only need to consider how much of your interest would have been deductible under either the MuA rules or the standard deductibility rules if a future disposal of the land with your main home and short-stay dwelling could be a taxable disposal.

A67. While it would not be common for property with a person's main home and a short-stay dwelling on it to be taxable on disposal, there are some situations where this could be the case, such as:

- Where the relevant residential or main home exclusion from the applicable land sales provision cannot be used for some other reason. For example, the land area requirements in s CB 16[79] are not met, or the land has not been used for most of the bright-line period for the person's main home (relevant for the main home exclusion from the 5-year bright-line test).[80]
- The main home exclusion from the bright-line test has already been used twice in the last two years or there is a regular pattern of transactions that mean the relevant exclusion cannot be used.[81]

A68. However, a future taxable disposal is most likely to arise under the 10-year bright-line test, when the main home exclusion to that test does not apply. This is because of the way the main home exclusion from the 10-year bright-line test operates – it is not an "all or nothing" exclusion like the main home exclusion from the 5-year bright-line test. Because this is the most common scenario that property with a person's main home and a short-stay dwelling could be taxable on disposal, the main home exclusion from the 10-year test is explained below.

A69. Under the 10-year bright-line test, an amount derived by a person from disposing of residential land[82] is income of the person if the disposal occurs within 10 years of the date of acquiring the land.[83] For the bright-line test, residential land includes land that

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[79] The residential exclusion from ss CB 6 to CB 11.

[80] Section CZ 40.

[81] Relevant for the main home exclusions from both the 5-year and 10-year bright-line tests (ss CZ 40(3) and CB 16A(3)).

[82] The 10-year test generally applies to land acquired on or after 27 March 2021. It does not apply to the extent the land is new build land (a 5-year bright-line period applies in that case).

[83] Subject to an exclusion or roll-over relief applying.

of the land used for the main home is larger than the area of the land used for your short-stay dwelling.[84]

[84] In the rare situation where the area of the land used for a short-stay dwelling is larger than the area of the land used for the main home dwelling, the main home exclusion will not apply.