

Holding costs for privately used land that is taxable on sale

A tax policy consultation document

October 2019

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First published in October 2019 by Policy and Strategy, Inland Revenue, PO Box 2198, Wellington 6140.

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ISBN 978-1-98-857306-9



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The Persistent URL for this document is <https://purl.org/nzir-tp/2019-004>

The document is available at
<http://taxpolicy.ird.govt.nz/publications/2019-ip-land-holding-costs/overview>

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CHAPTER 1

Background

- 1.1 As part of the Government's updated tax policy work programme, officials are reviewing the current land rules, particularly in relation to investment property and speculators, land banking, and vacant land. The objective is to recommend ways to improve the efficient use of land, and ensure that the current tax settings are fair, balanced, and encourage and support productive investment.
- 1.2 One of the issues being considered is the rules for the deductibility of holding costs for land that is taxable on sale and is used privately (in whole or in part) while it is held. For example, this will arise where a bach or second home is sold within five years so that the gain from the sale is taxable under the bright-line test. This will also arise where a person regularly purchases properties to renovate and sell, and lives in the properties while they own them.

The issues

- 1.3 Holding costs are costs such as interest, rates, insurance, and repairs and maintenance expenditure that are incurred as a result of owning land. It is generally accepted that, to the extent that land is used to earn taxable income, holding costs are deductible. So, if a person owns a rental property, holding costs are deductible in full (subject to the new rental ring-fencing rules) because those costs relate to the taxable rental income. Equally, if land is held by a land dealer, holding costs are deductible in full because those costs relate to the taxable income from the sale of the land.
- 1.4 However, our tax system does not allow deductions for expenditure to the extent that it is private or domestic in nature. This is known as the private limitation. This means that holding costs relating to a person's main home are not deductible.
- 1.5 While the law is relatively clear about the deductibility of holding costs where land is used solely for either income-earning or private use, the law is currently unclear about the treatment of holding costs where they relate to land that is subject to income tax on sale and is used privately while it is held. This consultation document considers this issue.
- 1.6 In determining the correct treatment for the deductibility of holding costs, this consultation document considers the following issues:
 - the extent to which holding costs should be deductible where land is subject to income tax on sale and is used privately, in whole or in part, while it is held; and
 - whether periods of vacancy should be treated as periods of either private use or income earning use.
- 1.7 This consultation document also proposes the following technical amendments to bring the legislation into line with established practice, to ensure that:
 - costs of acquisition and improvements to land are deductible where land is taxable on sale under the bright-line test or the various 10-year rules, despite there being

no knowledge that the land sale was going to be taxable when the expenditure was incurred; and

- the provision that allows a deduction for the costs of acquisition and improvements¹ overrides the private limitation so that the whole of those costs are deductible even if the land is used privately.

1.8 These proposed amendments are discussed in more detail in chapters 4 and 5.

1.9 These issues have arisen as a result of the introduction of the bright-line test, which brings more privately used land into the tax base. However, they can also arise in relation to land that is taxed under the other land sales rules. The proposals in this document are intended to apply to land taxed under the bright-line test and to land that is taxed under any of the other land sales rules.

Summary

Deductibility of holding costs for private use periods

1.10 This consultation document considers three options for the deductibility of holding costs for land subject to income tax on sale that is used privately. These options are:

- apportioning the holding costs between the taxable gain on sale and the private use of the land while it is held;
- allowing deductions for all holding costs, even though there is private use; and
- denying deductions for all holding costs for periods of private use.

1.11 These options are discussed in more detail in chapter 2.

1.12 While an apportionment approach would arguably be the most accurate option, it would not be consistent with other areas of New Zealand's tax law where no apportionment is required. Most obviously, holding costs for rental properties are fully deductible (subject to the new rental ring-fencing rules) even though those costs also often relate to a non-taxable capital gain.

1.13 Therefore, officials' current view is that denying deductions for all holding costs for periods of private use would be the best option.

Treatment of periods of vacancy

1.14 This consultation document also considers the correct tax treatment of holding costs relating to land that is not actively used and is taxable on sale. This is necessary to decide whether unused or vacant land should be treated as being used privately or for income earning purposes when determining deductibility. This is discussed in more detail in chapter 3.

1.15 Officials propose that the treatment of periods of vacancy as either private or income-earning use should be based on the other uses of the land throughout the period of ownership.

¹ Section DB 23 of the Income Tax Act 2007.

How to make a submission

- 1.16 Officials invite submissions on the proposed changes and points raised in this consultation document.
- 1.17 Send your submission to policy.webmaster@ird.govt.nz with “Holding costs for privately used land that is taxable on sale” in the subject line.
- 1.18 Alternatively, submissions may be posted to:
- Holding costs for privately used land that is taxable on sale
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140
- 1.19 The closing date for submissions is **1 November 2019**.
- 1.20 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it is acceptable for Inland Revenue officials to contact submitters to discuss the points raised, if required.
- 1.21 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their release. The withholding of particular submissions, or parts of submissions, on the grounds of privacy, or commercial sensitivity, or for any other reason, will be determined in accordance with that Act. Those making a submission who consider that there is any part of it that should properly be withheld under the Act should clearly indicate this.

CHAPTER 2

Deductibility of holding costs for private use periods

- 2.1 Holding costs are generally deductible where land is used to earn taxable income. However, the private limitation denies a deduction for an amount of expenditure or loss to the extent it is of a private or domestic nature.
- 2.2 The level of deduction that is allowed for holding costs in situations where there is some private use of the property and the sale of the property is taxed is currently unclear.
- 2.3 Three options for deductibility are discussed below.

Option 1: Apportionment

- 2.4 Holding costs relate both to any current year use of the land and to any eventual gain on sale. The holding costs could therefore be apportioned between the private-use benefit and the taxable gain on sale. For example, if a person received \$100 worth of private benefits from their private use of the land, and a \$100 taxable gain on sale, they would be entitled to a deduction of fifty percent of the holding costs on the basis that only fifty percent of the total benefit is taxable.
- 2.5 Arguably, apportioning holding costs between private and taxable benefits would be the most accurate approach. However, correct apportionment requires both the benefit of the current year use, and the income derived on sale, to be measurable. Measuring the value of the private benefit is likely to be difficult, and the taxable gains are not known until the property is sold. Therefore, accurate apportionment is likely to be complex. Simplified apportionment approaches could be developed (for example, fifty percent of holding costs are deductible for private use periods regardless of the values of the private and taxable benefits), however, these would be arbitrary and would compromise accuracy.
- 2.6 An apportionment approach would also be inconsistent with other areas of New Zealand's tax law where no apportionment for holding costs is required. For example, holding costs for rental properties held on capital account are fully deductible (subject to the new rental ring-fencing rules) even though those holding costs also relate to a non-taxable capital gain. Requiring apportionment in those circumstances would likely improve neutrality and fairness. However, it would be a significant change to the existing tax law and may increase complexity.

Option 2: Allow all deductions

- 2.7 The second option would be to allow deductions for holding costs in full, despite any private use, on the basis that the holding costs are all incurred in deriving the taxable income from sale. This bases deductibility on whether there is a taxable use of the land, regardless of whether there is a non-taxable or private use of the land.

- 2.8 Allowing deductions in full for holding costs during periods of private use would result in deductions being allowed for private expenditure. This is inconsistent with an important principle of New Zealand's tax framework.

Option 3: Deny all deductions

- 2.9 The final option would be to deny all deductions for holding costs for periods in which the land is used privately. For example, no deductions for holding costs would be allowed for a bach that is taxed on sale under the bright-line test but was used one hundred percent privately while it was held.
- 2.10 This option bases deductibility on the current year use of the land. If the current year use of land is income-earning, for example a rental property, deductions for holding costs would be allowed. Conversely, deductions would be denied if the current year use of land is private. Where current year use of land involves a mixture of both income-earning and private use, deductions would only be denied for the days where the land is used privately.
- 2.11 Consistent with the current rules for rental properties where deductions are allowed in full despite the gain on sale not being taxed, the taxable gain on sale would be ignored for determining the deductibility of holding costs.
- 2.12 This option is consistent with keeping private expenditure out of the tax base. This option is also consistent with the Tax Working Group's capital gains tax design recommendations, where it was recommended that no deductions should be allowed for holding costs where land is used privately.² It may also reduce compliance costs for bright-line taxpayers who would otherwise have to find prior year evidence to support deductions at the time of sale.
- 2.13 This option may be seen as unfair as it does not recognise the fact that the holding costs do relate in part to the taxable gain on sale. Furthermore, in situations where a person regularly purchases properties to renovate and sell, and lives in the properties while they own them, this approach would deny all holding costs (including repairs and maintenance expenditure) for the period in which they live in the properties.

Officials' views

- 2.14 An approach which apportions holding costs between the current year use and the gain on sale would arguably be the most accurate option. However, as noted, an apportionment approach would likely be complex, or sacrifice accuracy in order to reduce complexity.
- 2.15 Furthermore, an apportionment approach is inconsistent with other parts of the tax system where apportionment is not required. As noted, requiring apportionment in cases where the current year use is income-earning and the gain on sale is non-taxable would be a significant change to the existing tax law and is likely to increase complexity. Officials therefore do not propose changing the existing tax law to require apportionment in these circumstances.

² See the Tax Working Group's Final Report, Vol II, Chapter 4, paragraph 8.

- 2.16 In the absence of changing existing tax law to require apportionment when the gain on sale is non-taxable and the current year use is income earning, officials' view is that an apportionment approach is not appropriate for situations where the current year use is private and the gain on sale is taxable.
- 2.17 Instead, officials consider the best option is to deny deductions for holding costs for periods of private use.

Holding costs for different entities

- 2.18 For simplicity, the discussion has focused on land in individual ownership. However, land can be owned by a number of different entity types. Officials are aware that having different rules applying to different entity types might incentivise owners to move land into entities where the rules are perceived to be better. This is not considered to be a good outcome.
- 2.19 Officials consider the above proposals should apply in the same way for individuals, partnership, trusts, and look-through companies. For all of those entities, expenditure is only deductible where there is sufficient connection between the expenditure and income, or between expenditure and a business carried on for the purpose of deriving income. To the extent that land is used privately, holding costs will not be connected to any income. Therefore, the proposals to deny deductions (wholly or in part) for private use should affect individuals, partnerships, trusts, and look-through companies in the same way.
- 2.20 For most expenditure, the same principle applies to companies. If land owned by a company is used privately by its shareholders, and the company is deriving no income from that use, most holding costs will not be deductible to the extent of the private use. However, companies are generally entitled to full interest deductions whether or not the interest is connected to income. Therefore, taxpayers could choose to use a company to hold private land in order to obtain full interest deductibility.
- 2.21 While officials are aware of this potential inequity between companies and other structures it is not proposed that the rules should be changed for companies. While companies are allowed full interest deductions, private use of land by shareholders will either require the shareholders to pay full market rent to the company (which is taxable to the company and non-deductible to the shareholders) or would give rise to taxable dividend income for the shareholders. Private use of land by employees of the company will give rise to a benefit to the employee which is either taxable as employment income, or subject to FBT.
- 2.22 On that basis, officials consider that there are already rules that disincentivise company ownership of privately used land. However, officials are interested in whether there are other views on this issue.
- 2.23 Even if no changes are made to the rules for interest deductibility for companies, officials will monitor this area and consider changing the rules should taxpayers start to use this structure more.

CHAPTER 3

Treatment of periods of vacancy

- 3.1 The second issue is the correct tax treatment of holding costs relating to land that is not actively used and is taxable on sale. If deductions are denied (wholly or in part) as a result of private use, it is necessary to determine whether unused or vacant land should be treated as being used privately, or for income earning purposes.
- 3.2 The treatment of vacant or unused time as either private or income-earning could depend on the other uses of the land during the period of ownership. This would mean that:
- Where land is otherwise actively used either privately or for income-earning purposes, any vacant or unused days could be treated similarly. For example, where a person has a rental property that is vacant for a couple of months between tenants, that vacant time would still be treated as income-earning use. If a person has a bach that is wholly used for private purposes, unused time would be treated as private use.
 - Where land is used for both income-earning and private purposes and there are more than 62 days of vacant or unused time, the current “mixed-use asset rules” could continue to apply. These rules apportion vacant days based on the proportion of actual private and income-earning days (for example, if a bach is used privately for 20 days in a year and is rented through Airbnb for 20 days in a year and is otherwise vacant, fifty percent of the vacant days are treated as private days and fifty percent of the days are treated as income earning days).
- 3.3 Where land is wholly vacant or unused, the use could be considered income earning if:
- it is held for a business of dealing in, developing, or building on land;
 - it is held for another income-earning purpose (for example, land purchased to expand a current business onto, or to erect a rental property); or
 - the taxpayer otherwise informs the Commissioner at the time of purchase that the land was acquired solely with an intention of resale for profit.
- 3.4 In all other situations where land is wholly vacant or unused the use would be considered private.
- 3.5 This approach to the treatment of periods of vacancy ensures that legitimate businesses can still claim deductions for holding costs for periods of vacancy, while also ensuring that private expenditure is kept out of the base.
- 3.6 In contrast, treating all periods of vacancy as either wholly private or wholly income-earning use would either deny deductions for legitimate business expenditure, or allow deductions for private expenditure.

CHAPTER 4

Overriding the general permission

- 4.1 In most cases, there has to be sufficient connection between expenditure and income, or between expenditure and a business carried on for the purpose of deriving income before expenditure can be deducted. This is known as the general permission. Whether the general permission has been satisfied is judged at the time the expenditure is incurred.³
- 4.2 In some situations involving land subject to the land sale rules there may not be the required connection between expenditure on holding costs and income, because at the time the expenditure is incurred it may not be known whether the disposal of the land will be taxed.
- 4.3 This may be the case, for example, with land that is taxed if sold within a particular timeframe (that is, 5 or 10 years). The issue may also arise where land is taxed if certain circumstances eventuate during the time the land is held (for example, if a division or development is carried on, or if the land increases in value because of a zoning change, within 10 years of acquiring the land).
- 4.4 This issue is relevant because the provision that allows for the cost of acquisition and improvements to the land to be deducted (section DB 23) is subject to the general permission being satisfied.
- 4.5 It was clearly intended that the cost of land that is taxed under any of the land sale rules would be deductible, so that only the net proceeds are income (or a loss). That is how the provisions operated prior to the rewrite of the Income Tax Act, under the “profits or gains” approach. However, it seems that the splitting out of income and deductions into separate provisions may have inadvertently created some uncertainty in respect of land taxed under some of the land provisions.
- 4.6 In situations where it is not known or anticipated at the time land is acquired that the disposal will be taxed, but it transpires that one of the land sale rules does in fact apply, the cost of the land may not currently technically be deductible under section DB 23. This is because there is not be the requisite nexus between the cost of the land (at the time that is incurred) and expected future income.
- 4.7 To address this issue it is proposed that section DB 23 be amended so that it overrides the general permission for disposals of revenue account property.
- 4.8 Should it be decided that holding costs should be deductible where there is no income-earning current use of the land, an amendment will also be needed to allow for deductions of those costs where it is not known at the time the costs are incurred that the sale of the land will be taxable.

³ *CIR v Banks* (1978) 3 NZTC 61,236 (CA).

CHAPTER 5

Overriding the private limitation

- 5.1 The current provision that allows deductions for the costs of acquisition and improvement of land (section DB 23) is subject to the private limitation. Therefore, technically, where there is private use of land that is subject to tax on sale, part of the costs of acquisition and improvements should also be denied to take into account the private benefit received.
- 5.2 However, officials are of the view that private use should not affect the deductibility of acquisition and capital improvement costs. As noted, these costs should be fully deductible at the time of sale, no matter how the property is used while it is held to ensure that only the net proceeds are income.
- 5.3 To address this issue it is proposed that section DB 23 should also be amended so that it overrides the private limitation.