Inland Revenue
Te Tari Taake

FACT SHEET | PUKA MEKA

# Deductibility of holding costs for land

Issued | Tukuna: 3 November 2023

IS 23/10 FS

This fact sheet accompanies Interpretation Statement **IS 23/10**. IS 23/10 considers the deductibility of holding costs for land, and whether the land being taxed on sale is relevant to deductibility. This fact sheet explains what the conclusions in IS 23/10 mean for the deductibility of your holding costs, depending on your circumstances.

All legislative references are to the Income Tax Act 2007, unless otherwise stated.

# Key terms | Kīanga tau tāpua

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| **Bright-line test** | The bright-line test taxes sales of residential property owned for less than 5 or 10 years (depending on when the property was acquired). Some sales may not be taxed, for example if the property was the owner's main home (if it meets the relevant criteria). |
| **Holding costs** | Holding costs for land are expenses relating to owning land, such as interest, rates, property insurance, and repairs and maintenance and body corporate levies (provided they are not capital expenses – for example, for capital improvements). |
| **Holding land on capital account** | Holding land on capital account is when you're not holding the land for income-earning (taxable) sale. Property you weren't holding for taxable sale but that ends up being taxed on sale (for example, under the bright-line test) is held on capital account. |
| **Holding land on revenue account** | Holding land on revenue account is when you know the land will be taxed on sale. For example, if you bought it with the intention of resale and no exclusion applies, so the sale will be taxed. |
| **Interest limitation rules** | The interest limitation rules may apply to residential property to disallow interest deductions, either fully or (for some properties during the phase-in period for the rules) in part.<br><br>Some residential properties are not subject to the rules, so interest is deductible (for example, properties that meet the criteria to be considered a new build and properties held on revenue account because the taxpayer is in a land-related business, like being a land dealer or developer).<br><br>Interest that's disallowed only because of the interest limitation rules may be deductible on a taxable sale. |
| **Mixed-use asset rules** | The mixed-use asset rules set out the extent deductions are allowed if, during the income year, a property earns rental income, is used privately and is unused for 62 days or more. |
| **Ring-fencing rules** | The ring-fencing rules may apply to limit the deductible expenses you can claim in a particular income year.<br><br>The rules generally apply to residential land if the expenses for the year are more than the income (that is, the property or a portfolio |

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| | of properties of which the property is a part, is loss-making for the year).<br><br>If the ring-fencing rules apply, deductions up to the amount of income can be claimed that year. The excess deductible amount is carried forward and may be used in a future year.<br><br>Land that's covered by the mixed-use asset rules is not subject to the ring-fencing rules. Some other residential land may not be subject to the rules, such as land held on revenue account, or land to the extent it's the owner's main home. There are criteria that need to be met for these exclusions from the rules to apply.<br><br>For land held on revenue account (other than in a s CB 7 land-related business), the exclusion from the ring-fencing rules applies only if the owner has told Inland Revenue the property is held on revenue account. This generally has to be done by the date the owner has to file their tax return for the income year they acquire the land. See further s EL 10(2) and (3). |

# Introduction | Whakataki

1. IS 23/10 considers the deductibility of holding costs for land, and whether the land being taxed on sale is relevant to deductibility. This fact sheet explains what the conclusions in IS 23/10 mean for the deductibility of your holding costs, depending on your circumstances.
2. Holding costs are expenses incurred in relation to owning land, such as interest, rates, property insurance, and repairs and maintenance and body corporate levies (provided they are not capital expenses – for example, for capital improvements).

# General principles

3. For holding costs to be deductible, the first rule is that there has to be a sufficient connection between the expenses and earning income or carrying on a business. The use or uses of the property determine whether this sufficient connection exists. You have to consider what the property is used for each income year.
4. Income-earning uses of property include renting it out and holding it on revenue account (that is, for taxable sale).
5. Holding property on capital account is not an income-earning use, even if the sale of the property ends up being taxed (for example, under the bright-line test). This is

because the deducibility test requires looking at what the taxpayer was seeking to gain from the expenditure at the time it was incurred. If a property is held on capital account, the taxpayer isn't incurring holding cost expenditure in order to derive assessable income. The fact assessable income is derived if the sale ends up being taxed doesn't alter the deductibility of holding costs. The tax rules require you to look at the situation at the time you incur the expense.

6. However, Inland Revenue will accept that holding costs for land held on capital account are deductible (subject to any apportionment that needs to be made because of private use, and to the interest limitation rules) from the time there is a binding contract to sell the land, if the sale will be taxed. There may be situations where the Commissioner would accept holding costs being deducted[1] from an earlier point in time that is reasonably close to when a binding contract for (taxable) sale is entered into, but this will be highly fact-dependent.

7. If the property is used for earning income, so the required connection between expenditure and income exists, other rules could limit how much of your holding costs can be deducted. These rules include that:

   - deductions are not allowed to the extent the expense is a private expense (for example, if you or family or friends use the property); and
   - interest deductions for residential properties may be denied either fully or in part under the interest limitation rules.

8. If your allowable deductions for the property (or a portfolio of properties you own) are more than the income from the property (or portfolio), the ring-fencing rules may apply to limit the amount you can deduct that year. If the amount you can deduct is limited under the ring-fencing rules, the excess is carried forward and may be used in a future year.

9. If some or all of your interest is non-deductible only because of the interest limitation rules, it will become deductible if the sale of the property is taxed. The ring-fencing rules may still apply to limit the amount of the deduction you can claim that year.

[1] Again, subject to any required apportionment and to the interest limitation rules.

# If you hold a property on revenue account

## No private use

10. If you hold a property on revenue account and don't use it privately, holding costs for the property are fully deductible, except any interest that's disallowed under the interest limitation rules.
11. The deduction for your deductible holding costs is claimed in the year the expenses are incurred, subject to the ring-fencing rules.
12. Any interest that's disallowed under the interest limitation rules becomes deductible in the year of sale (see [19]).

### Example | Tauira 1 – Land held on revenue account and not used privately

Mary buys a house (that's not her home) to do up and on-sell. She does not sell it during the income year as the renovation work is not complete. She can deduct all her holding costs, subject to the interest limitation rules (which may mean some or all interest is non-deductible).

Mary can claim the deductible holding costs in the year they are incurred, subject to the ring-fencing rules (if Mary hasn't told Inland Revenue the property is held on revenue account).[2] The ring-fencing rules may mean Mary can't claim some deductions in the income year and instead carries them forward to a future year. For example, if the ring-fencing rules apply and Mary does not make any income from the property in the year (because she doesn't rent it out and didn't sell it during the year) and she has no income from other residential properties, she can't claim the deductions in the income year. This is because Mary wouldn't have any income from residential land and the ring-fencing rules limit the deductions claimed in the year to the amount of income from residential land. In this situation, Mary's holding cost deductions would be carried forward to the next income year.

[2] The requirements for this are in s EL 10(2) and (3).

## Some private use

13. If you hold a property on revenue account and also use it privately, holding costs for the property are partly deductible. The extent of the deduction depends on how much private use there is compared to income-earning use.

14. First, work out the total amount of your holding costs. Subtract from that any interest that's non-deductible in the year because of the interest limitation rules. Apportion the total amount remaining between periods of private use and periods there wasn't private use.

15. For periods of private use, Inland Revenue will accept a 50% deduction. Whether there is private use for any period the property is vacant depends on the overall circumstances. For example, if it's your second home and you spend half the week there, days you aren't there count as private use days. But if, for example, it's a property you're doing up to sell and you stay there for a couple of weeks because you have various contractors lined up and it's a bit of a drive from your home so it's more convenient to just stay at the property, those days wouldn't count as private use and the vacant days wouldn't either.

16. For any periods the property is not used privately, holding costs are fully deductible, except any interest that's disallowed under the interest limitation rules.

17. You claim the deduction for your deductible holding costs in the year the expenses are incurred, subject to the ring-fencing rules.

18. Any interest that's disallowed under the interest limitation rules becomes deductible in the year of sale (see [19]).

### Example | Tauira 2 – Land held on revenue account and used privately

Bruce buys a house to do up and sell and he lives in it for the nine months it takes him to renovate. He then puts the property on the market and moves into the next house he will renovate. The property sells six weeks later. The sale is taxed under the intention test (s CB 6); the residential exclusion from the intention test (s CB 16) will not apply in Bruce's circumstances because he has a regular pattern of living in houses while he renovates them before sale. Bruce buys and sells the property in the same income year.

Bruce's holding costs are deductible only in part, because he is using the property both privately (as he lives there while renovating it) and to earn income on sale. In this situation, Inland Revenue would accept Bruce deducting 50% of his holding costs for the period he lived at the property. His holding costs are fully deductible for the period he didn't live at the property.

Bruce claims the deductible holding costs in the income year they are incurred. The ring-fencing rules don't apply to change this, because by filing his tax return and declaring the income from the sale Bruce meets the requirement to tell Inland Revenue the property is held on revenue account.

Because Bruce bought and sold the property in the same income year and the sale is taxed, none of his interest is disallowed under the interest limitation rules. If Bruce did not sell the property in the same income year he bought it, the interest limitation rules may mean some or all interest is non-deductible until the year of taxable sale.

### When you sell the property

19. Any interest you can't deduct while you own the property, only because of the interest limitation rules, becomes deductible in the year of the taxable sale of the property. The ring-fencing rules may still apply to limit the amount of the deduction you can claim that year.

## If you hold a property on capital account

### Income-earning use and no private use

20. If you hold a property on capital account, use it to earn income and don't use it privately at all, holding costs are fully deductible for the income-earning periods, except any interest that's disallowed under the interest limitation rules.

21. Holding costs are not deductible for any non-income earning period unless the property is committed to an income-earning process although there's no actual income in that period (for example, if there's a small gap between one tenant moving out and a new tenant moving in).

22. You claim the deduction for your deductible holding costs in the year the expenses are incurred, subject to the ring-fencing rules.

23. What happens if the property ends up being taxed on sale (for example, under the bright-line test) is discussed from [30].

**Example | Tauira 3 – Land held on capital account, used to earn income and not used privately**

Louise has a rental property. She can deduct all of her holding costs, subject to the interest limitation rules (which may mean some or all interest is non-deductible).

Louise can claim the deductible holding costs in the year they are incurred, subject to the ring-fencing rules.

This is still the case if there's a gap between tenants (for example, a three-week gap between tenants while Louise re-paints the interior).

## Income-earning use and private use

24. If you hold a property on capital account, use it to earn income and use it privately, holding costs for the property are deductible in part. The extent of the deduction depends on the amount of private use compared with income-earning use and whether the mixed-use asset rules apply.

25. First, work out the total amount of your holding costs. Subtract from that any interest that's non-deductible because of the interest limitation rules. You then need to apportion the total amount remaining between the periods of income-earning use and private use of the property to calculate the deductible portion.

26. To help you determine whether the mixed-use asset rules apply and, depending on whether they do, how you should calculate the deductible portion of your expenses, see:

    - QB 19/06: *What income tax rules apply if I have a dwelling that I sometimes rent out as short-stay accommodation and sometimes use myself?* (Inland Revenue, Wellington, May 2019);
    - QB 19/07: *How do the mixed-use asset income tax rules apply to a dwelling that I sometimes rent out as short-stay accommodation and sometimes use privately?* (Inland Revenue, Wellington, May 2019); and
    - QB 19/08: *How do the standard income tax rules apply to a dwelling that I sometimes rent out as short-stay accommodation and sometimes use privately?* (Inland Revenue, Wellington, May 2019).

27. The deduction for the allowable portion of your holding costs is claimed in the year the expenses are incurred, subject to the ring-fencing rules.

28. What happens if the property ends up being taxed on sale (for example, under the bright-line test) is discussed from [30].

**Example | Tauira 4 – Land held on capital account, used to earn income and used privately**

Tommy has a bach he sometimes uses himself and sometimes rents out. Tommy has to apportion his deductible holding costs, because he's using the property both privately and to earn income. He can deduct the holding costs apportioned to the income-earning use of the property, subject to the interest limitation rules (which may mean some or all interest is non-deductible).

The bach is vacant for 62 or more days in the income year, so the mixed-use asset rules apply. Those rules provide a formula for apportioning most of the deductible property-related expenses, including holding costs. Tommy uses *QB 19/07* to help calculate how much he can deduct.

The deductible portion of holding costs is claimed in the year the costs are incurred, subject to the ring-fencing rules (which apply if the mixed-use asset rules don't apply).

## No income-earning use

29. If you hold a property on capital account, and don't use it to earn any income, holding costs for the property are not deductible. This includes if the sale of the property ends up being taxed (for example, under the bright-line test). However, Inland Revenue will accept that holding costs for land held on capital account are deductible[3] from the time there is a binding contract to sell the land, if the sale will be taxed. There may be situations where Inland Revenue would accept holding costs being deducted[4] from an earlier point in time that is reasonably close to when a binding contract for (taxable) sale is entered into, but this will be highly fact-dependent.

[3] Subject to any apportionment that needs to be made because of private use, and to the interest limitation rules.

[4] Again, subject to any required apportionment and to the interest limitation rules.

**Example | Tauira 5 – Land held on capital account, not used to earn income and taxed on sale**

In May 2021, Mark and Sophie buy a vacant block of land on which they plan to build their new home. Before they start the build, Sophie gets offered her dream job in Australia, so the couple decide to sell the block and move there. They have not used the land at all.

The land is sold within the 10-year bright-line period that applies (because the land was acquired after 26 March 2021), so the sale is taxed.

Mark and Sophie's holding costs are (generally) not deductible, because they were not using the property to earn income. That fact assessable income is derived on the sale (because the bright-line test applies) doesn't (generally) alter the deductibility of holding costs. The tax rules require you to look at the situation at the time you incur the expense. However, Mark and Sophie can deduct their holding costs from the time the contract for the sale of the land is entered into until the settlement date for the sale. They can fully deduct their holding costs for that period because they haven't used the land at all.

## If the sale of the property is taxed

30. Any interest you can't deduct while you own the property, only because of the interest limitation rules, becomes deductible if the sale of the property is taxed. Whether you can claim the deduction (or all of the deduction) in that year depends on your circumstances, as explained next.

31. If the sale is taxed under the bright-line test, the interest previously disallowed only because of the interest limitation rules gets added to the cost of the property,[5] which you can deduct from the sale proceeds. However, there's a rule that limits the cost deduction you can claim in the year to the amount of income you have from land sales. This means if your bright-line sale is loss-making, you may not be able to claim the full cost deduction that year. Any excess cost deduction you can't claim that year gets carried forward and you may be able to use it in a future year if you derive income from another property sale.

32. If the sale is taxed under a rule other than the bright-line test, the ring-fencing rules may apply to limit the amount of the deduction you can claim that year.

[5] Subject to potential adjustment if the property has been used as a main home at all.

**Example | Tauira 6 – Land held on capital account, used to earn income, not used privately and taxed on sale**

Louise from Example 3 sells her rental property within the 10-year bright-line period that applies to her.

Any interest she was not able to deduct only because it was disallowed by the interest limitation rules is added to the amount she can deduct for the cost of the property.

She originally bought the property for $750,000. She spent $30,000 adding a deck to the property (the only capital improvement she made). And the interest she would have been able to deduct over the years she rented the property out, if not for the interest limitation rules, totals $75,000. She sold the property for $1million.

Louise can claim the deductible holding costs (rates and property insurance) in the year they are incurred, subject to the ring-fencing rules. The interest she incurs on the loan for the property isn't deductible in the years before the year of sale, only because of the interest limitation rules.

In the year of the sale, the interest deductions that were disallowed only because of the interest limitation rules are added to the cost of the property, because the sale is taxed under the bright-line test. The total cost of the property is, therefore, $855,000 (the purchase price of $750,000 plus the $30,000 deck plus the $75,000 interest that was disallowed only because of the interest limitation rules).

Louise's income from the sale of the property ($1 million) is more than her cost deduction ($855,000), so she can claim the full cost deduction in the year of sale.

## About this document | Mō tēnei tuhinga

Some of the Tax Counsel Office's longer or more complex items are accompanied by a fact sheet that summarises and explains an item's main points. While it summarises the Commissioner's considered views a fact sheet should be read alongside the full item to completely understand the guidance. Fact sheets are not binding on the Commissioner. See further Status of Commissioner's advice (*December 2012*).