Inland Revenue
Te Tari Taake

INTERPRETATION STATEMENT | PUTANGA WHAKAMĀORI

Deductibility of holding costs for land

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IS 23/10

This Interpretation Statement considers the deductibility of holding costs for land and whether the land being taxed on sale is relevant to deductibility. Holding costs are expenses incurred in relation to the ownership of land, such as interest, rates, property insurance, and repairs and maintenance and body corporate levies (provided they are revenue expenses). Holding costs do not include capital improvement costs or expenses that relate only to the use of land.

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

SUPERSEDES | WHAKAKAPIA

- **IS0082:** This Interpretation Statement supersedes comments in ***IS0082***: *Interest deductibility* – Public trustee v CIR (Inland Revenue, May 2006) that *Pacific Rendezvous Ltd v CIR* [1986] 2 NZLR 567 (CA) is authority for interest being fully deductible where all of the borrowed funds are used in an income-earning activity, despite also having some other use – irrespective of the nature of that other use.

  The Commissioner no longer considers that correct and is now of the view that *Pacific Rendezvous* is not authority for interest being fully deductible where land is used both privately and for income-earning.

- **QB 19/08:** This Interpretation Statement supersedes any statements or conclusions in ***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, May 2019) to the extent they are inconsistent with this Interpretation Statement in terms of deductibility of holding costs for periods land is vacant and where the mixed-use asset rules do not apply.

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This Interpretation Statement assumes the taxpayer is **not a company**, so s DB 7 is not relevant to interest deductibility and ss DG 10 to DG 14 do not apply.

Summary | Whakarāpopoto

1. This interpretation statement considers the deductibility of holding costs for land and whether the land being taxed on sale is relevant to deductibility. The term holding costs refers to expenses incurred in relation to the ownership of land, such as interest, rates, property insurance, and repairs and maintenance and body corporate levies (provided they are revenue expenses).[1] Holding costs do not include capital improvement costs or expenses that relate only to the use of land.

2. There is a flowchart at [47] to help determine whether, and if so to what extent, holding costs for a particular property are deductible. There is also a fact sheet, IS 23/10 FS, that explains the deductibility outcomes without the detailed explanation and analysis in this Interpretation Statement.

Nexus with income

3. The first requirement for expenditure to be deductible is that it must be incurred by a person either:

   - in deriving assessable income or excluded income or a combination of the two, or
   - in the course of the person carrying on a business for the purpose of deriving assessable income or excluded income or a combination of the two.

4. This means that to be (potentially) deductible, there must be a sufficient nexus between the expenditure and an income-earning process of the taxpayer's. Income does not need to be derived in the year the expenditure is incurred.

5. To determine whether there is a sufficient nexus between holding cost expenditure and the taxpayer's income-earning process, it is necessary to identify the advantage the taxpayer was seeking to gain from the expenditure. It is necessary to consider the factual situation at the time the expenditure was incurred.

[1] See [51].

6. The use to which land is put is relevant in determining whether holding costs satisfy the nexus requirement in s DA 1. This is true for interest as well as other holding costs, because:

   - The advantage obtained from the payment of interest is the use of borrowed money, so where borrowed money is used to acquire land, whether the interest is (on the face of it) deductible depends on the use to which the land is put in the period in which interest is incurred.
   - The advantage obtained from incurring other land holding costs is the continued use and enjoyment of the land, so the use of the land determines whether there is a sufficient relationship between those expenses and the taxpayer's income-earning process.

7. Because holding costs are revenue expenses and (generally)[2] deductible as they are incurred (if they are deductible),[3] the use or uses of the land need to be considered in each income year as the use of the land may change from one year to the next.

8. Land can be used concurrently by more than one person, and can be used concurrently by one person for more than one purpose.

9. The use of land generally means the physical use or occupation of the land (for example, if the property is rented out or stayed at by the owner).

10. However, land may also be used without being physically used, and holding land for resale is a use of land. As such, where land is held on revenue account (for example, under s CB 6 or s CB 7), one use of the land is that it is being held for taxable sale. Therefore, there will be a sufficient nexus between the expenditure and the taxpayer's income-earning process. Whether land is held on revenue or capital account, if it is used to earn rental income, the nexus requirement will be satisfied.

11. If there is some income-earning use of the land (because it is held on revenue account or used to earn rental or other income or both), apportionment may be required (with the expenditure being deductible only in part) if the land is also used privately during some or all of the period it is held (for example, if the taxpayer uses the property for holidays).

12. Where land is held on capital account, it cannot be said that a use of the land is that it is being held for income-earning sale. The property is not committed to an income-earning activity of taxable sale during the period of ownership. The fact the sale of the land may end up being taxed (for example, under the bright-line test) does not alter

[2] But see footnote 25 on page 33. Note also that s EA 3 (Prepayments) may potentially be relevant to insurance premiums – see [49].

[3] Note that the interest limitation rules in subpart DH may apply to disallow (or partly disallow) interest deductions.

what it was that the taxpayer was seeking to gain from incurring the expenditure. Therefore, the nexus requirement of the general permission will generally be satisfied in respect of holding costs only if there is current year income-earning (or anticipated income-earning) use of the land (for example, rental use). However, the Commissioner would accept that holding costs for land held on capital account are deductible[4] from the time a binding contract for the sale of land is entered into, if the sale will be taxed. There may be situations where the Commissioner would accept holding costs being deducted[5] from an earlier point in time reasonably close to when a binding contract for (taxable) sale is entered into, but this will be highly fact-dependent.

13. If the nexus requirement of the general permission is satisfied for interest, the rules in subpart DH will need to be considered. Subpart DH disallows interest deductions for many residential properties purchased on or after 27 March 2021 and progressively phases out interest deductions for many residential properties purchased before then.

14. Interest deductions that are disallowed by the interest limitation rules in subpart DH may become deductible if the property is sold and the sale is taxed. If this is the case, the amount that becomes deductible is only the amount that would have been allowed but for subpart DH; for example, the appropriately apportioned amount if apportionment is necessary (see from [15]).

Apportionment

15. The general permission in s DA 1 allows for deductibility only *to the extent* expenditure satisfies the nexus requirement. The private limitation (s DA 2(2)) denies deductibility *to the extent* expenditure is of a private or domestic nature. These provisions clearly contemplate apportionment (meaning expenditure may be deductible only in part).

16. The extent to which holding costs are deductible depends on whether there are other uses of the land (for example, private use), and if so, whether the mixed-use asset rules (the MUA rules) in subpart DG apply. This is because the MUA rules contain a formula that deals with the apportionment of most deductions for certain mixed-use assets, including land.

Whether the mixed-use asset rules apply

17. The MUA rules apply if, in an income year, the land is:

- used privately (which includes use by natural person associates, or anyone renting it out for less than 80% of the market value rent);

[4] Subject to any required apportionment and to the interest limitation rules.

[5] Subject to any required apportionment and to the interest limitation rules.

- used to derive income; and
- unused for a least 62 days.

18. "Use" in the MUA rules is defined as "the active use of the asset for its intended purpose". Therefore, land being held on revenue account is not relevant in determining whether the MUA rules apply.

19. If the criteria at [17] are met, a taxpayer can opt out of the MUA rules for the asset in two situations. These situations are where:
    - the gross income from the property for the year is under $4000; or
    - the taxpayer would otherwise have quarantined expenditure under the MUA rules for the year.[6]

If the mixed-use asset rules apply

20. Where the MUA rules apply, most deductible property-related expenses will be apportioned under a specific formula in the rules. If the land is held for income-earning sale (that is, it is held on revenue account), that is not a relevant use of the land for the apportionment formula.

If the mixed-use asset rules do not apply (other than because of opting out)

21. If the MUA rules do not apply (other than because the taxpayer has opted out of them), general apportionment principles are used to determine the extent to which holding cost expenditure is deductible.

22. The purpose of apportionment is to ascertain how much of the expenditure is attributable to the deductible item (in this case, income-earning use) and how much is attributable to the non-deductible item (in this case, private use). Apportionment must be fair and not arbitrary.

Land held on revenue account (that is, held for taxable sale)

23. If land is held on revenue account and the MUA rules do not apply (other than because of opting out) the fact the land is being held for taxable sale is a relevant use of the land in determining deductibility of holding costs. As such, holding costs will be deductible in full (if there is no private use) or in part (if there is private use).

[6] This will be the case if the income from the property for the year is less than 2% of the property's value and the deductible expenses for the property under the MUA rules exceed the income.

24. If land is held on revenue account, used privately, but not actively used to earn income (for example, rental income), the MUA rules will not apply.

25. It is also possible that land could be held on revenue account, used to earn current year income, used privately during the year, and the MUA rules not apply (other than because of opting-out).

26. In either of these situations, there will be periods of simultaneous income-earning use (being held for taxable sale) and private use of the land.

27. The Commissioner considers that in most situations where land is simultaneously used for income-earning (because it is held on revenue account) and used privately, the most appropriate approach is to apportion on a percentage basis by reference to the relative importance of the income-earning and private uses.

28. In the Commissioner's view, 50:50 is generally an appropriate starting point for apportionment for periods of simultaneous income-earning use (because the property is held on revenue account) and private use. The provisions that mean land is on revenue account do not require a dominant purpose of disposal, and it is difficult to see (absent a particular factual situation) how either the income-earning use or the private use could be considered a more dominant or important use. However, the Commissioner would accept any other basis for apportionment that is fair and reasonable in a taxpayer's particular circumstances.

29. For periods a property held on revenue account and sometimes used privately is vacant or physically unused, the extent of deductibility for holding costs depends on whether there is considered to be non-physical or non-active use of the property. This will be highly fact-specific and requires considering the overall circumstances.

Land held on capital account (that is, not held for taxable sale)

30. Where land is held on capital account (that is, not held for taxable sale) and there is both income-earning use and private use of the property but the MUA rules do not apply (other than because of opting out), a time-based or time- and space-based apportionment between the current year income-earning and private uses of the property is generally appropriate. Deductible holding costs are fully deductible for periods the property is rented out or available to be rented out.[7] Holding costs are not deductible for periods of private use or periods the property is not available to be rented out.

31. If there is no current year (or anticipated) income-earning use of land (for example, rental use), the general permission will not be satisfied in respect of holding costs if the

[7] Subject to any space-based apportionment (for example, if people renting the property out cannot use some areas).

land is held on capital account. As such, holding costs are not deductible. This is generally the case even if the land ends up being taxed on sale, for example, under the bright-line test. This is because property that is held on capital account is not committed to an income-earning activity of taxable sale during the period of ownership, when holding costs are incurred.

32. However, the approach to apportionment of holding costs would differ from the time a binding contract for the sale of land is entered into, if the sale will be taxed (or potentially earlier, as discussed at [93]). If there is private use of the property between the sale contract being entered into and the date the sale is settled, the Commissioner would accept a 50:50 apportionment as a starting point for those periods, and full deductibility for any time in this period there is no private use.

If the mixed-use asset rules have been opted out of

33. If a taxpayer opts out of the MUA rules for an asset, the income from the "use" of the asset is exempt income.

34. Because "use" is defined in the MUA rules as "the active use of the asset for its intended purpose", only income from the active use (for example, rental) of the asset is exempt income. Any income from the sale of land (that is, if one of the land sale rules applies) is not exempt income.

35. The Act denies deductions for expenditure to the extent to which it is incurred in deriving exempt income.

36. If a property is held on capital account, not sold in the year, and the MUA rules are opted out of, holding costs for that year will not be deductible because they will have been incurred in deriving only exempt income. If the sale ends up being taxed, some holding costs may be deductible (see [159]).

37. If a property is held on revenue account and the MUA rules are opted out of, holding costs will be deductible subject to appropriate apportionment. The discussion on apportionment summarised at [21] to [29] is relevant in this scenario, although in this scenario the additional use of deriving exempt income needs to be factored in.

Ring-fencing

38. Once the deductible portion of holding costs has been calculated, the ring-fencing rules in subpart EL may apply to limit the deductible expenses that can be claimed in a particular income year.

39. 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 of properties it is part of, is loss-making for the year). If the ring-fencing rules apply, deductions up to the amount of income

can be claimed that year. The excess deductible amount that cannot be claimed that year is carried forward and may be used in a future year.

40. Land in the MUA 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 is the owner's main home. Relevant criteria need to be met for these exclusions from the rules to apply (ss EL 10 and EL 9).

Deductible "cost" of land on taxable sale

41. If the sale of property (including land) is taxed, a deduction for the "cost" of the property is allowed under s DB 23.

42. The Act does not define "cost" for the purposes of s DB 23. Case law has established that the term cost can have various meanings, depending on context.

43. The Commissioner considers that the meaning of "cost" of property in s DB 23 is the generally understood meaning of the term, being that which is given to acquire something. For land, this includes the initial outlay to acquire the land as well as the cost of capital improvements, as these form part of the land.

44. Holding costs for land that is taxed on sale do not (generally) form part of the cost of the land. They are expenses incurred in relation to the ownership of land not its acquisition. Therefore, they are not deductible under s DB 23.

Taxable sale – interest limitation and ring-fencing rules

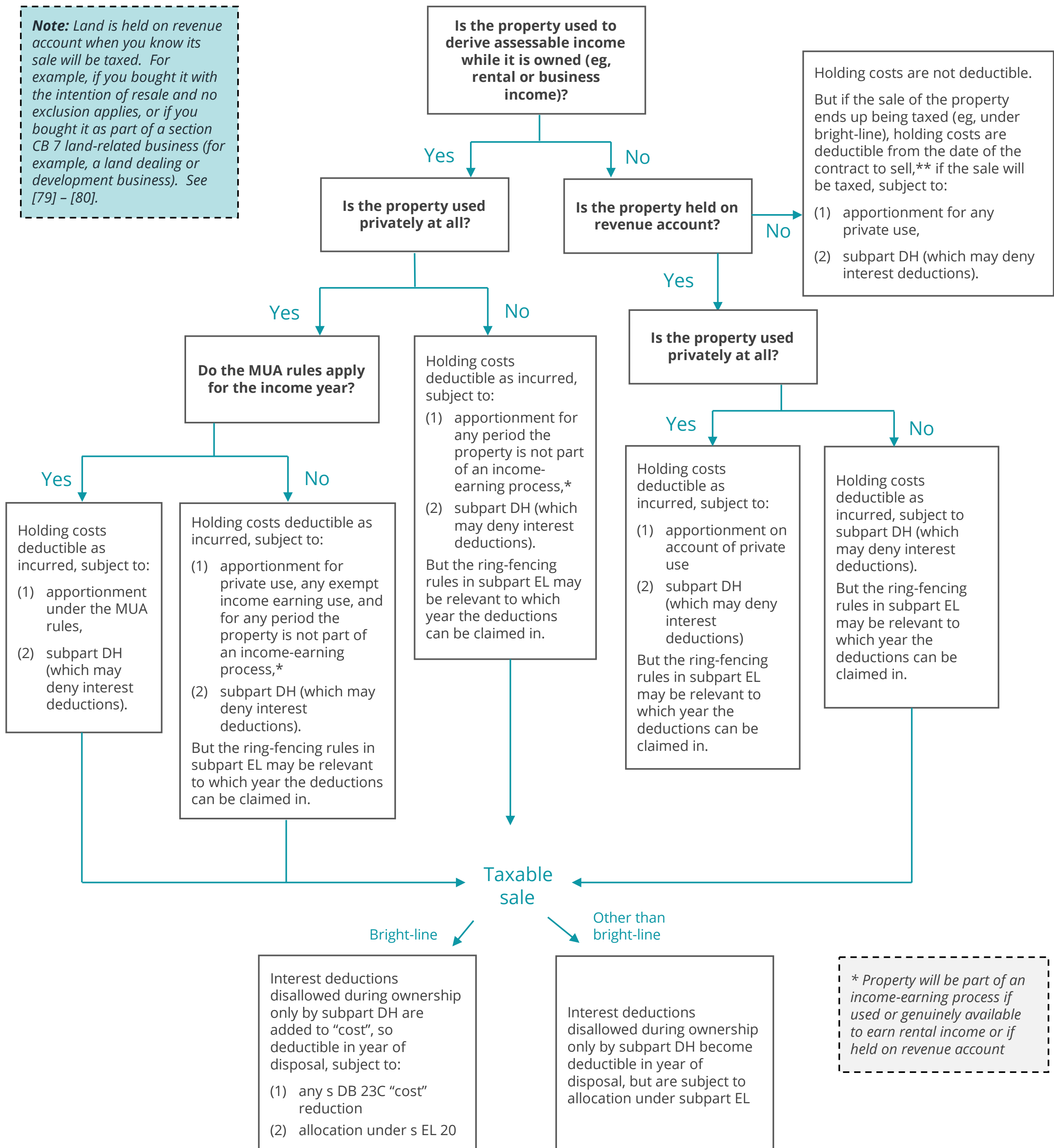
45. However, if land is taxed under the bright-line test, interest deductions previously disallowed only because of the interest limitation rules in subpart DH are treated as part of the cost of the land. This means those amounts become deductible on the taxable bright-line sale, subject to: (1) a reduction if there has been some main home use of the property, and (2) the bright-line loss quarantine rule in s EL 20.

46. If land is taxed under a provision other than the bright-line test, interest deductions previously disallowed only because of the interest limitation rules are allowed as a deduction in the year of sale. However, these deductions (together with other deductions for the property or a portfolio of properties it is part of) are subject to the ring-fencing rules in subpart EL,[8] which may limit the extent to which the deductions are allocated to the income year in question.

[8] Unless an exclusion from the ring-fencing rules applies.

Diagram | Hoahoa: Flowchart – Deductibility of holding costs for land

47. Use the following flowchart to help determine whether, and if so to what extent, holding costs for land are deductible. In all circumstances where holding costs are deductible, note it may be necessary to consider s EA 3 (see [49]).



Introduction | Whakataki

What are holding costs?

In this Interpretation Statement, the term holding costs refers to revenue expenses incurred in relation to the ownership of land, such as interest, rates, property insurance, and repairs and maintenance and body corporate levies (provided they are revenue expenses).[9] Holding costs do not include capital improvements or expenses that relate only to the use of land.

48. We have been asked to clarify the Commissioner's position on the deductibility of holding costs for land taxed on sale under the land sale rules. In particular, we have been asked whether (and if so, the extent to which) holding costs are deductible if land is subject to the bright-line test (ss CB 6A and CZ 39). But the issue also arises for land subject to any of the other land sale rules (ss CB 6 to CB 15).

49. When the whole property is used to earn rental or other income for the whole time it is owned, holding costs are deductible, subject to the:

- interest limitation rules – which deny interest deductions for many residential properties purchased on or after 27 March 2021, and progressively phase out interest deductions for many residential properties purchased before then; and
- ring-fencing rules – which limit the deductions that can be taken in any year that deductions exceed income from the property (or a portfolio of properties that the taxpayer owns).

Note also that s EA 3 may potentially be relevant to insurance premiums, if there is an unexpired portion of the expenditure at the end of the person's income year that is not covered by the 12-month exemption in Determination E12: *Persons excused from complying with section EA 3 of the Income Tax Act 2007* (Inland Revenue, March 2009). If s EA 3 applies, the unexpired portion of the expenditure at the end of the income year is income for the person that year, and they are allowed a deduction for that amount in the following income year.

50. But where the property (or part of the property) is not used to earn rental or other income (for example, it is vacant or used privately – whether for the whole time the property is owned or just for periods), there is uncertainty about whether holding costs are deductible (in full or part) on the basis that the ultimate sale of the property is taxed.

51. As noted in the above description of what holding costs are, repairs and maintenance and body corporate levies are included provided they are revenue expenses. IS 12/03: *Income Tax – Deductibility of repairs and maintenance expenditure – General principles* (Inland Revenue, June 2012) will help you identify whether particular repairs and

[9] See [51].

maintenance expenditure is revenue. In terms of body corporate levies, a portion may be a revenue expense and a portion capital – it depends what the particular portion of the levy will be used for. For example, the portion of the levy that will go to the long-term maintenance fund would likely be revenue. However, it would be necessary to consider the long-term maintenance plan to determine if some of the planned maintenance (to be funded by the long-term maintenance fund) would in fact be capital expenditure. If so, the revenue (and so potentially deductible) portion would need to be identified. If there is a capital improvement fund, the portion of the levy that will go to that would be capital, so not deductible. If a taxpayer cannot reasonably identify if a particular portion of a body corporate levy relates to revenue or capital expenditure, it should not be deducted.

Analysis | Tātari

The issues

52. Three main issues are relevant to the deductibility of holding costs for land that is taxed on sale.

53. The first issue is whether there is a sufficient nexus between the expenditure and an income-earning process to satisfy the general permission for deductibility (s DA 1).

54. The second issue is whether, in a situation where there is the required nexus to satisfy the general permission, holding costs should be apportioned (and be deductible only in part). This needs to be considered because:

- the general permission allows for deductibility only *to the extent* expenditure is incurred in deriving assessable income or in the course of carrying on a business for the purpose of deriving assessable income; and
- the private limitation (s DA 2(2)) denies deductibility *to the extent* expenditure is of a private or domestic nature.

55. The third issue is whether holding costs for land that is taxed on sale form part of the cost of the property. This issue is relevant to:

- the timing of any allowable deduction for holding costs, because if holding costs are part of the cost of the land, they would be deductible at the time the property is sold rather than in the year they are incurred (ss DB 23 and EA 2);
- the ability to deduct holding costs for property held on capital account that is not used to derive current year (or anticipated) income, but that ends up being taxed on sale (for example, under the bright-line test), because a deduction is allowed under s DB 23(1) even if the general permission is not satisfied; and

- whether holding cost expenditure needs to be apportioned on account of private use of the property if the property is taxed on sale, because, in addition to supplementing the general permission, s DB 23(1) also overrides the private limitation.

56. These issues are considered in turn below.

Whether there is a sufficient nexus between holding cost expenditure and income

57. The first requirement for expenditure to be deductible is that it must be incurred by a person either:

- in deriving assessable income or excluded income or a combination of the two (s DA 1(1)(a)), or
- in the course of the person carrying on a business for the purpose of deriving assessable income or excluded income or a combination of the two (s DA 1(1)(b)).

58. This rule is known as the general permission. The general permission is set out in s DA 1:

> **DA 1 General permission**
>
> *Nexus with income*
>
> (1) A person is allowed a deduction for an amount of expenditure or loss, including an amount of depreciation loss, to the extent to which the expenditure or loss is—
>
> (a) incurred by them in deriving—
>
> (i) their assessable income; or
>
> (ii) their excluded income; or
>
> (iii) a combination of their assessable income and excluded income; or
>
> (b) incurred by them in the course of carrying on a business for the purpose of deriving—
>
> (i) their assessable income; or
>
> (ii) their excluded income; or
>
> (iii) a combination of their assessable income and excluded income.
>
> *General permission*
>
> (2) Subsection (1) is called the **general permission**.
>
> …

59. This means that to be (potentially) deductible, the expenditure has to have the necessary relationship with the taxpayer and with the gaining or producing of assessable income or with the carrying on of a business for that purpose. In other words, there must be a sufficient nexus between the expenditure and an income-earning process of the taxpayer's.

60. If the general permission is satisfied, there are some general limitations (in s DA 2) to deductibility, including that deductions are denied to the extent expenditure is of a private or domestic nature (the private limitation) and to the extent it is of a capital nature (the capital limitation).

61. Section DB 6 provides for the deductibility of interest. It overrides the capital limitation, so a deduction for interest cannot be denied on the basis that the expenditure is capital expenditure. However, the general permission and other general limitations still apply. In addition, subpart DH contains specific rules for interest deductions. Those rules deny interest deductions for many residential properties purchased on or after 27 March 2021 and progressively phase out interest deductions for many residential properties purchased before then.

62. This Interpretation Statement assumes the taxpayer is not a company. This means s DB 7, which provides that most companies are allowed a deduction for interest without needing to satisfy the general permission, is not relevant to interest deductibility.

The nexus requirement under the general permission

63. The degree of nexus, or connection, required to satisfy each of the two limbs of deductibility (s DA 1(1)(a) and s DA 1(1)(b)) is the same, although it is measured in different contexts, non-business and business (*NRS Media Holdings v C of IR* (2018) 28 NZTC 23,079 (CA)).

64. To determine whether there is a sufficient nexus between expenditure and an income-earning process of the taxpayer's, it is necessary to ascertain the true character of the expenditure and consider the relationship between the advantage the taxpayer was seeking to gain from the expenditure and the taxpayer's income-earning process. See, for example, *CIR v Banks* [1978] 2 NZLR 472 (CA) and *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA).

65. Whether there is a sufficient nexus between the expenditure and the income-earning process depends on the particular facts. But it is clear that it is necessary to consider the factual situation **at the time the expenditure was incurred**, which is when the taxpayer has become definitively committed to the particular item of expenditure. This was noted in *Banks* (judgment delivered by Richardson J at 477):

> The statutory requirement is that the expenditure be "incurred in gaining or producing the assessable income". **That has to be judged as at the time that the taxpayer became definitively committed to the expenditure for which deduction is sought** …
>
> …
>
> **It then becomes a matter of degree, and so a question of fact, to determine whether there is a sufficient relationship between the expenditure and what it provided, or sought to provide, on the one hand, and the income earning process, on the other, to fall within the words of the section**.
>
> [Emphases added]

66. Importantly for present purposes, income does not need to be produced in the year in which the expenditure is incurred. Expenditure may be incurred before or after the derivation of the income it relates to. As long as there is a sufficient connection between the expenditure and the taxpayer's income-earning activity, the expenditure will satisfy the nexus requirement for deductibility. This is clear from *Eggers v CIR* [1988] 2 NZLR 365 (CA), where the court said from 372:

> While for fiscal and administrative reasons income tax is calculated on annual income, the tax system must recognise the continuing nature of much business and other income earning activity. It does so in numerous ways and both limbs of sec 104 [now s DA 1(1)] also reflect that reality in linking deductibility to gaining or producing the assessable income "for any income year". That clearly covers the case of a continuing business or existing income earning activity.
>
> …
>
> … **In short, an expenditure may precede or succeed related income so long as, applying the general tests under the respective limbs, there is a sufficient nexus between expenditure and income earning activity**. …
>
> [Emphases added]

67. In *Slater v CIR* [1996] 1 NZLR 759 (HC), Fisher J also noted that income does not need to be derived in the year the expenditure is incurred. Provided the purpose of the expenditure is the production of assessable income and there is the required nexus between the activity in respect of which the deduction is claimed and intended income, the expenditure will be deductible (subject to any required apportionment, the general limitations, and any other rules in the Act). Fisher J commented at 767:

> … It has been consistently held that to qualify as a deductible activity for the purpose of provisions of that kind two conditions must be satisfied: first the purpose of the expenditure, interest or use of an asset must be the production of income and secondly there must be some reasonable nexus between the activity in respect of which the deduction is claimed and the intended income. **But so long as those two conditions**

> **are satisfied, the deduction can be claimed in the year of the deductible activity without waiting for derivation of the proposed income**: *Eggers v C of IR* (1988) 10 NZTC 5,153; [1988] 2 NZLR 365 (CA) at NZTC pp 5,160, 5,161; NZLR p 373, *Ward & Co Ltd v Commissioner of Taxes* [1923] AC 145 at p 148, *Hugh v Bank of New Zealand* (1938) 21 DC 472 at p 524, *Ash v C of T (SW)* (1938) 61 CLR 263 at p 272.
>
> [Emphasis added]

Relevance of the use of the land

68. To determine whether there is a sufficient nexus between holding cost expenditure and the taxpayer's income-earning process, it is necessary to identify the advantage the taxpayer was seeking to gain from the expenditure.

69. The **use to which land is put** is relevant in determining whether holding costs satisfy the nexus requirement in s DA 1. As explained from [70], this is true for interest as well as other holding costs.

70. Interest is paid for the use of money. The advantage obtained from the payment of interest is the use of borrowed money. Where borrowed money is used to acquire land, whether the interest is (on the face of it)[10] deductible depends on the use to which the land is put in the period in which interest is incurred (*Pacific Rendezvous*).

71. Liability to pay rates arises as an incident of the ownership or occupation of land (*Bryan v Opotiki District Council* (HC, Tauranga CIV-2006-470-703, 26 September 2006)). In *Australian National Hotels Ltd v FCT* 88 ATC 4627 (FCFCA) Bowen CJ and Burchett J commented that the advantage sought during recurring periods of insurance is the continued availability of the asset that is insured. Similarly, repairs and maintenance and body corporate levies (which fund things such as maintenance and insurance for common areas) provide the advantage of the continued use and enjoyment of the property.

72. As such, for taxpayers who are not companies, the same statutory test applies to all land holding costs, and the same factual matters (the use to which the land is put during the period in which expenditure is incurred) are relevant in determining whether and the extent to which holding cost expenditure satisfies the general permission in s DA 1. This is consistent with *Case J66* (1987) 9 NZTC 1,393 and *Case M46* (1990) 12 NZTC 2,280 (which were decided after *Pacific Rendezvous*), in which the Taxation Review Authority applied the same test to all holding costs.

73. This Interpretation Statement assumes the taxpayer is not a company, so s DB 7 will not be relevant to interest deductibility.

[10] Note that the interest limitation rules in subpart DH may apply to disallow (or partly disallow) interest deductions.

Use (or uses) of land taxed on sale

74. As the **use to which land is put** determines whether holding costs satisfy the general permission for deductibility, the question then is: what is the use (or are the uses) of land that is taxed on sale?

75. Because holding costs are (generally)[11] deductible as they are incurred (if they are deductible),[12] the use or uses of the land need to be considered in each income year, as the use of the land may change from one year to the next.

Non-physical uses of the land are relevant

76. The use of land generally means the physical use or occupation of the land (*Brake v Inland Revenue Commissioners* [1915] 1 KB 731 and *Thornton Estates Ltd v CIR* (1998) 18 NZTC 13,577 (CA)). However, land may also be used without being physically used. Holding land for resale is a use of land. The land is being held as a means of achieving something – a profit on sale. As the Court of Appeal said in *Sloss v Sloss* [1989] 3 NZLR 31 at 36:

> The physical occupation of property is clearly a use of that property. In its ordinary meaning, "use" is not, however, confined in that way. In its natural meaning it is a word of wide import. ... **The owner of land may be said to use the land when, without doing anything on that land, he obtains advantages from the land** (*Newcastle City Council v Royal Newcastle Hospital* [1959] AC 248, 255) and in *R v Heyworth* (1866) 14 LT 600, 601 Lush J observed that: "The owner 'uses' the place [a slaughter house] by letting it out". Even the giving away of property may be a "use" of that property (*R v Wampole (Henry K) & Co* [1931] 3 DLR 754)).
>
> [Emphasis added]

Multiple concurrent uses of land

77. It is also clear that land can be used concurrently by more than one person; for example, by the owner of the premises and by someone leasing the premises (*FCT v Tourapark Pty Ltd* (1980) 33 ALR 153 (FCAFC) and *Ryde Municipal Council v. Macquarie University* (1978) 23 ALR 41 at 45 (FCHCA)).

78. Similarly, land can be used concurrently by one person for more than one purpose; for example, it can be held for resale (which is an income-earning use if the sale will be

[11] But see footnote 25 on page 33. Note also that s EA 3 (Prepayments) may potentially be relevant to insurance premiums – see [48].

[12] Note that the interest limitation rules in subpart DH may apply to disallow (or partly disallow) interest deductions.

taxable) and also used privately by the owner during the period of ownership (for example, if it is used by the owner for holidays).

Holding land on revenue account is an income-earning use of the land

79. Several provisions in the Act mean land is held on revenue account, so the amount derived on its disposal will be income. Where this is the case, one use of the land is that it is being held for taxable sale. For example, land will be on revenue account from the time it is acquired if:

    - it was acquired for a purpose or with an intention of disposal (s CB 6), and no exclusion is available;
    - at the time the land was acquired the taxpayer or an associated person was in the business of dealing in land, or developing or subdividing land, and the land was acquired for the purpose of the business (s CB 7), and no exclusion is available.

80. Land may also move from being held on capital account to being held on revenue account at some time during the ownership period. This would be the case once the criteria for the eventual disposal of the land being taxed have been met, for example, if:

    - within 10 years of acquiring land, the taxpayer starts an undertaking or scheme involving more than minor development or division of the land (s CB 12), and no exclusion is available;
    - the taxpayer carries on an undertaking or scheme involving significant expenditure on development or division work in relation to land, and no exclusion is available.

81. During some or all of the period land held on revenue account is owned, it may also be used to earn current year income or used privately or both. Therefore, at any time, the land may be used for multiple simultaneous or concurrent uses.

Holding land on capital account is not income-earning use of the land, even if the disposal of the land ends up being taxed

82. In other situations, land is held on capital account but its disposal ends up being taxed (for example, land taxed under the bright-line test (s CB 6A or s CZ 39) or under one of the 10-year rules (ss CB 9 to CB 11)).

83. In the Commissioner's view, it cannot be said that in these situations a use of the land was that it was held for income-earning sale. During the ownership period, there is not sufficient certainty the sale of the property will end up giving rise to income (being taxed) – there is just a possibility that it would.

84. There is in a sense a relationship between holding costs incurred and the earning of income on sale. Holding costs are incurred over the same period as the increase in value of the land occurs, so it can therefore be argued that holding costs are necessarily incurred in deriving the income.

85. However, the nexus required to meet the general permission is between the expenditure and an income-earning process. A benefit that is too remote or indirect will not satisfy the nexus test. Crucially here, the property is not committed to an income-earning activity of taxable sale during the period of ownership. There is merely the **potential** during the relevant period (for example, 5 or 10 years) for the ultimate sale to be taxed.

86. The Commissioner does not consider that there is a sufficient nexus between expenditure on holding costs and an income-earning process if there is no current year (or anticipated) income-earning use of the land (for example, rental use), just the possibility that the land will be taxed when sold. As Judge Barber noted in *Case T16* (1997) 18 NZTC 8,095, while income need not be received in the same period, there must be an **expectation** that income will be received (at 8,097):

> For interest to be deductible the borrowed funds must be *used* **to seek assessable income** (for any year) in the period in which the deduction is sought ie in general terms, expenditure must be in the course of business rather than preparatory to commencement of business. It is not necessary for income to be received in the same period, but **there must be an expectation that income will be received** — *Eggers v C of IR*.

[Bold emphases added]

87. It has been suggested that because there will generally be an expectation that land will increase in value, there is a nexus between holding cost expenditure and expected profit. It is submitted that the fact a person does not know the profit will be taxable should not mean the nexus requirement for deductibility is not met; it is just not known what the tax implications will be (that is, whether the profit will be income or capital).

88. While s DA 1 does not contain a temporal requirement (that is, the income to which the expenditure relates does not need to be derived in the same income year), the advantage the taxpayer seeks to gain from the expenditure has to be the derivation of assessable income or excluded income or a combination of the two. That is, there has to be a sufficient relationship between the expenditure and the taxpayer's business or other income-earning process.

89. If land is not part of or committed to an income-earning process, the Commissioner considers that expenditure in relation to the land cannot have the requisite nexus with an income-earning process. The fact the Act may bring what would otherwise be a

capital receipt in as income does not alter what it was that the taxpayer was seeking to gain from incurring the expenditure. The requirements for deductibility are tested at the time expenditure is incurred and this is (subject to any specific timing rule) when the expenditure is deductible. Deductibility turns on the facts at that time (as noted in *Banks* – see [65]), not what subsequently transpires.

90. Therefore, where land is held on capital account but ends up being taxed on sale, it cannot be said that a use of land was that it was held for income-earning sale. The only basis for deductibility under s DA 1 of holding costs for land held on capital account (where there is no certainty that the disposal will be taxed, although this may subsequently turn out to be the case) is there being some current year (or anticipated) income-earning use of the land. However, there may be situations where the Commissioner would accept holding costs being deducted[13] because it is expected that the sale of land held on capital account will be taxed – this is discussed from [92].

91. If there is anticipated income to be derived from the property (for example, the property is advertised as available for rent, but not actually rented during the year), the nexus requirement in s DA 1 may be satisfied. However, the taxpayer would be expected to be able to show they had a genuine expectation that income would be earned. This may require the taxpayer to demonstrate that the property was genuinely available for rent; for example, by providing evidence of active and regular marketing of the property at market rates and that the property is available at times and for periods that show it is genuinely available to rent.

92. The Commissioner would accept that holding costs for land held on capital account are deductible (subject to any required apportionment and to the interest limitation rules) from the time a binding contract for the sale of land is entered into, if in the circumstances that means the sale will be taxed.[14] For example, the Commissioner would accept holding costs being deducted[15] from the time a binding contract for the sale of residential land within the relevant bright-line period has been entered into, if no exclusion from the bright-line test applies so the sale will be taxed.

93. There may be situations where the Commissioner would accept that holding costs for land held on capital account are deductible[16] from an earlier point in time that is reasonably close to when a binding contract for (taxable) sale is entered into. The Commissioner would expect the taxpayer to be able to show actions they had taken that evidence they were committed to selling the property and had a genuine and

[13] Subject to any required apportionment and to the interest limitation rules.

[14] Even though there is not *complete* certainty the vendor will derive income (for example, if the contract is cancelled in circumstances where the deposit is not retained by the vendor).

[15] Subject to any required apportionment and to the interest limitation rules.

[16] Subject to any required apportionment and to the interest limitation rules.

reasonable expectation from that time that the sale would be taxed. Whether a taxpayer can show this will be highly fact-dependent.

Vacant periods

94. There is a question as to what the use or uses of land are during periods it is physically unused or vacant. This issue arises only where the MUA rules do not apply. If the MUA rules apply, it is only the active uses of the asset that are relevant (see from [114]).

95. The Commissioner does not consider there is necessarily an element of private use of a land during periods of vacancy by virtue of the property being available for private use. However, as noted at [76], land may be used without being physically used. The question then is whether property can be considered to be used privately in a non-physical or non-active sense (that is, in vacant periods).

96. In the Commissioner's view, this comes down to an assessment of what 'use' of an asset in a particular way entails. Private use of land does not necessarily require physical presence. For example, if a person is away on holiday for two weeks there is no question their home is still being used privately by them in their absence and property-related expenditure would be of a private or domestic nature. Similarly, if someone had a home in a rural area and also an apartment in the city that they stay at during the work week, the Commissioner considers that there would be private use of the apartment every day not just on days the taxpayer is staying there. In this situation, the apartment is being held and maintained essentially as a second home. Normal use of a home (or second home) involves periods of absence from the home.

97. The Commissioner considers that whether a property is being used (or partially used) privately in any vacant period will be highly fact-specific and requires considering the overall circumstances.

98. It should be noted that *de minimis* or incidental private use can be ignored. For example, in *Commissioner of Taxation v Dixon Consulting Pty Ltd* (2006) ATC 4832; (2006) 65 ATR 290; [2006] FCA 1748, Emmett J indicated that private use could be fairly characterised as *de minimis* if it were "so slight that it should be ignored". And in *CIR v Haenga* [1986] 1 NZLR 119 (CA), the taxpayer's (compulsory) contributions to a welfare fund were held not to be of a private or domestic nature, with Richardson J commenting (at 128) that "any personal satisfaction derived from membership of the welfare society and the availability of benefits is only an incidental effect of the expenditure". If there is *de minimis* private use of a property only, there is no question of there being any non-physical or non-active private use of the property during vacant periods.

99. If there is considered to be private use during any vacant periods and there is also income-earning use in those periods (for example, because the property is held on

revenue account or because it is genuinely available for rent), apportionment would be required for those periods (see from [101]).

100. To the extent any statements or conclusions in [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, May 2019) are inconsistent with the discussion from [94], QB 19/08 is superseded by this Interpretation Statement. In particular, QB 19/08 indicates that full deductibility is allowed for nights a dwelling is rented out or available to be rented out. However, if there is considered to be private use in the periods of vacancy (as discussed above), the Commissioner considers that apportionment would be required for those periods.

Whether apportionment is required, with holding cost expenditure being only partly deductible

Whether apportionment is required

101. As noted at [54], the general permission in s DA 1 (set out at [57]) only allows for deductibility *to the extent* expenditure satisfies the nexus requirement. The private limitation (s DA 2(2)) also requires apportionment, denying deductibility *to the extent* expenditure is of a private or domestic nature. Section DA 2(2) provides:

> **DA 2 General limitations**
>
> ...
>
> *Private limitation*
>
> (2) A person is denied a deduction for an amount of expenditure or loss *to the extent to which* it is of a private or domestic nature. This rule is called the **private limitation**.
>
> [Italicised emphasis added]

102. It is clear that ss DA 1 and DA 2(2) contemplate apportionment. A deduction is potentially allowable only to the extent that the general permission is satisfied and the private limitation does not apply. This is true of all expenditure, including expenditure that serves both income-earning and other purposes indifferently (*Banks*, *Buckley & Young* and in *CIR v Atlantic & Pacific Travel International Ltd* (1993) 15 NZTC 10,024).

103. Some holding costs for a residential property are fixed regardless of whether the taxpayer uses the property for private purposes. The fact expenditure is fixed regardless of whether (or the extent to which) property is used for private purposes does not mean apportionment is not required. Apportionment of fixed costs is

required if part of the costs are attributable to a private objective (*CIR v Eales* (1987) 9 NZTC 6,203 (HC)).

104. In *Pacific Rendezvous*, borrowed money was used for both a capital purpose (to increase the capital value of the assets for sale) and an income-earning purpose (to increase the profitability of the business in the meantime). The court held that the interest was fully deductible because while there were two simultaneous uses of the property, the borrowed money was at all times employed in producing income. The use of the asset for capital purposes was disregarded as not being a "competing use".

105. The two uses of the borrowed funds in *Pacific Rendezvous* were income-earning and capital. However, the Commissioner took the view in *IS0082*: *Interest deductibility –* Public trustee v CIR (Inland Revenue, May 2006) that *Pacific Rendezvous* states a broader principle, and is authority for interest being fully deductible where all of the borrowed funds are used in an income-earning activity, despite the interest also having some other use – whether capital or private.

106. The Commissioner no longer considers that correct and is now of the view that *Pacific Rendezvous* is **not** authority for interest being fully deductible where land is used both privately and for income-earning.

107. This is because in *CIR v Brierley* [1990] 3 NZLR 303 (CA), the court (judgment delivered by Richardson J) clarified that the capital use of borrowed money was not regarded as a "competing use" because the allowance of a full deduction for interest where a capital asset is used simultaneously for both income-earning and capital purposes is consistent with the scheme of the legislation. The court in *Brierley* considered that Parliament must have recognised that a capital asset used in producing assessable income may also produce capital gains or returns. However, the legislation permits a deduction for the cost of the use of capital and does not deny a deduction for interest on capital used in producing income because of the existence of actual or prospective capital gains or returns. This reasoning does not apply where there are both income-earning and private uses of the asset acquired with the borrowed money.

108. Section DB 6, which was enacted as part of the rewriting of the Income Tax Act, clarifies the relationship between s DB 6, the general permission, the capital limitation and the private limitation in a way that is consistent with the above view. As s DB 6 overrides the capital limitation, a deduction for interest is allowed if the general permission is satisfied and a deduction for interest could not be disallowed on the basis that the borrowed money is used to produce both income and capital gains or returns (s DB 6(4)). However, the private limitation still applies to interest.

109. For these reasons, the Commissioner no longer considers that *Pacific Rendezvous* is authority for interest being fully deductible where all of the borrowed funds are used in an income-earning activity, despite also serving some other purpose – irrespective of

the nature of that other purpose. This Interpretation Statement supersedes the comments to that effect in IS0082.

110. The Commissioner considers that *Brierley* confirms that the principle in *Pacific Rendezvous* applies only where the other use of the borrowed money is a capital use. The Commissioner's view is that if there are simultaneous uses of borrowed money, and one of those is a private use, apportionment is required and any interest deduction available is disallowed to the extent of the private use.

111. Therefore, if land has been used for some or all of the time for private use, it is necessary to apportion land holding cost expenditure (including interest, if otherwise deductible), with the expenditure being deductible in part only.

How holding cost expenditure should be apportioned where there are different uses of land

112. Because holding costs are (generally)[17] deductible as they are incurred (if they are deductible),[18] the use or uses of the land need to be considered in each income year, as the use of the land may change from one year to the next.

113. If there is income-earning use of land (including where no income has been received but the property is committed to an income-earning process and income is expected to be derived), the extent to which holding costs are deductible depends on whether there are other uses of the land (for example, private use), and if so, whether the MUA rules apply.

Whether the MUA rules apply

114. The MUA rules apply where an asset (including land) is, in an income year:

- used privately (this includes use by natural person associates, or by anyone renting it out for less than 80% of the market value rent);
- used to derive income; and
- unused for at least 62 days.

115. "Use" in the MUA rules is defined as "the active use of the asset for its intended purpose" (s DG 3(7)). Active use of land for its intended purpose would include use such as a dwelling being used for accommodation, fruit trees being grown and tended to in an orchard, or a parking lot being used for car parking. If land is held on revenue

[17] But see footnote 25 on page 33. Note also that s EA 3 (Prepayments) may potentially be relevant to insurance premiums – see [48].

[18] Note that the interest limitation rules in subpart DH may apply to disallow (or partly disallow) interest deductions.

account or otherwise committed to an income-earning process but not actively used to earn income (such as rental income), that use is not considered an income-earning use in terms of whether the MUA rules apply.

116. If the criteria at [114] are met, in two situations a taxpayer can opt out of the MUA rules for the asset (s DG 21). These situations are:

- where the gross income from the property for the year is under $4,000; or
- where the taxpayer would otherwise have quarantined expenditure under the MUA rules for the year.[19]

117. For further guidance on determining whether the MUA rules apply, 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, May 2019).

If the mixed-use asset rules apply

118. Where the MUA rules apply, they prescribe:

- which expenses are fully deductible (certain expenses that relate solely to the derivation of income); and
- the basis for apportionment for all other deductible property-related expenses (other than capital expenses, which may be deductible under s DB 23 if the property is subject to tax on sale).

119. Some holding cost expenditure may be fully deductible under the MUA rules; for example, additional rates or insurance premiums paid (over and above what would otherwise be payable) because the property is rented out. However, other than expenditure of that nature, if the MUA rules apply, land holding costs are apportioned under the formula in the MUA rules.[20]

120. The formula takes into account the number of "income-earning days". These are (relevantly) the days in the year for which the owner derives income from the "use" of the asset.

121. As noted at [115], use is defined in the MUA rules as "the active use of the asset for its intended purpose". Therefore, if the MUA rules apply, the apportionment will take into account only days the property is actively used to earn income (for example, days the property is rented out). If the land is held for income-earning sale, that is not a relevant use of the land for the apportionment formula.

[19] This will be the case if the income from the property for the year is less than 2% of the property's value and the deductible expenses for the property under the MUA rules exceed the income (s DG 16).

[20] This Interpretation Statement assumes the taxpayer is not a company. This means the special rules that apply if a mixed-use asset is owned by a company (ss DG 10 to DG 14) do not apply.

122. The effect of the formula is that holding cost expenditure is apportioned based on the number of income-earning days divided by the number of income-earning days plus "counted days" (days the asset is in use that are not income-earning days). For example, if a property is rented out for 100 days in the year and used privately for 50 days, two thirds of the expenditure subject to apportionment under the formula (including holding costs) is deductible (100 income-earning days divided by 150 income-earning days plus counted days).

123. The MUA rules, and the definitions of the above terms, are discussed in detail in *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, May 2019).

124. However, since the publication of QB 19/07, additional rules have been enacted that mean interest deductions for many residential properties will no longer be available. These rules are in subpart DH and mean interest deductions are:

- denied for residential properties purchased on or after 27 March 2021, unless an exclusion or exemption applies;
- progressively phased out for residential properties purchased before then, unless an exclusion or exemption applies; and
- not allowed from 1 October 2021 for new borrowings drawn down on or after 27 March 2021.

125. Interest may, therefore, need to be considered separately from other holding cost expenditure. This is the case even where the MUA rules apply, as the interest limitation rules in subpart DH override the MUA rules (s DG 2(3B)). QB 19/07 should be read subject to the interest limitation rules in subpart DH.

126. Interest deductions that would have been allowed if not for the interest limitation rules in subpart DH may become deductible if the land is sold and the sale is taxed (s DH 11). See further from [172].

127. Further information about the interest limitation rules is on Inland Revenue's website.[21]

If the mixed-use asset rules do not apply

128. If there is income-earning use of land (including where no income has been received but the property is committed to an income-earning process and income is expected to be derived) and private use of the land and the MUA rules do not apply, general

[21] For example, Property interest limitation rules (webpage, Inland Revenue, last updated 5 July 2022) or search the Inland Revenue website for "interest limitation rules".

apportionment principles should be used to determine the extent to which holding cost expenditure is deductible.

129. The purpose of apportionment is to ascertain how much of the expenditure is attributable to the deductible item (income-earning use) and how much is attributable to the non-deductible item (in this instance, private use). Apportionment must be fair and not arbitrary. The circumstances of a particular case will determine the most appropriate way of ascertaining how much of the expenditure is attributable to the deductible compared with non-deductible uses. See for example *Buckley & Young*.

130. Apportionment for land held on revenue account (that is, held for taxable sale) is discussed from [131]. Apportionment for land held on capital account (that is, not held for taxable sale) is discussed from [143].

Land held on revenue account (that is, held for taxable sale)

131. If land is held on revenue account (for taxable sale), used privately, but not actively used to earn income (for example, rental income), the MUA rules will not apply (see [115]).

132. It would not be a common scenario, but it is possible that land could be held on revenue account, used to earn current year income, used privately during the year, and the MUA rules not apply (other than because of opting out).

133. In either of these scenarios, in some periods there will be simultaneous income-earning use (being held for taxable sale) and private use. In the second scenario, in other periods there will be simultaneous income-earning uses (being held for sale and being used to earn current year rental or other income).

134. There is a question as to how holding cost expenditure should be apportioned for periods where there is simultaneous income-earning use (being held for taxable sale) and private use.

135. There are several possible approaches to apportionment where there are simultaneous income-earning and private uses of land.

136. The purpose of apportionment is to ascertain how much of the expenditure is attributable to the deductible items compared with the non-deductible items (in this case, uses of the land). Apportionment must be fair and not arbitrary, and the circumstances of a particular case determine the most appropriate method of apportionment.

137. In the Commissioner’s view, 50:50 is generally an appropriate starting point for apportionment for periods of simultaneous income-earning use (because the land is held for taxable sale) and private use. The provisions that mean land will be on taxable on sale do not require a dominant purpose of disposal, and it is difficult to see (absent

a particular factual situation) how either the income-earning use or the private use could be considered a more dominant or important use. However, the Commissioner would accept any other basis for apportionment that is fair and reasonable in a taxpayer's particular circumstances.

138. In periods the property is vacant or physically unused, the property is used for income-earning as it is committed to an income-earning process, being held for taxable sale. Whether holding costs are fully-deductible for these periods depends on whether there is considered to be non-physical or non-active private use of the property. This will be highly fact-specific. See further from [94].

The interest limitation rules

139. If part of the holding cost expenditure for land is interest, it is necessary to apply the interest limitation rules in subpart DH to determine the amount of interest (if any) that can be deducted (subject to apportionment) – see from [124].

The ring-fencing rules

140. If, after appropriate apportionment, the allowable deductions for the property (or portfolio of properties it is part of) exceed income from the property (or portfolio) for the year, the ring-fencing rules in subpart EL may apply to limit the amount of deductions that can be taken in the current year (with any excess being carried forward).

141. The ring-fencing rules do not apply to assets in the MUA rules (s EL 12), but the situation we are considering here is one where the MUA rules do not apply.

142. The ring-fencing rules also do not apply if the exclusion for land held on revenue account is satisfied (s EL 10). But note that in some situations (for example, for land that is held on revenue account because it was acquired with the intention of resale) the taxpayer needs to have notified the Commissioner that the property is held on revenue account – which, depending on the circumstances, may need to be done by the return filing date for the year the property was acquired. If the requirements for the exclusion for land held on revenue account have not been met, the ring-fencing rules may also need to be considered.[22]

Land held on capital account (that is, not held for taxable sale)

143. In situations where land is held on capital account (that is, not held for taxable sale) and there are both income-earning and private uses of the property but the MUA rules do not apply (other than because of opting out), a time-based or time- and space-

[22] While less likely, the main home exclusion from the ring-fencing rules could potentially apply here (see s EL 9).

based apportionment of holding costs between the current year income-earning use and the private use of the property is appropriate.

144. For example, if a bach not held for taxable sale is sometimes rented out and sometimes used privately, but the MUA rules do not apply (for example, because the bach is unused for less than 62 days in the income year), a time-based apportionment is generally appropriate. Deductible holding costs[23] are fully deductible for periods the property is rented out, subject to any space-based apportionment required (for example, if people renting the property out cannot use some areas). Holding costs are not deductible for periods of private use or periods the property is not available to be rented out. Deductibility for periods the property is vacant depends on whether the property is genuinely available to be rented out and whether there is considered to be non-physical or non-active private use of the property. This will be highly fact-specific. See further from [94].

145. For further guidance on how to apportion holding costs (and other expenditure) in this situation, see QB 19/08.

146. In some situations, a property may be used for income-earning (for example, rental) and simultaneously for private use; for example, if a taxpayer occasionally rents out a room in their house for short-stay accommodation and the guests can use common areas such as the lounge, kitchen and bathroom.

147. For guidance on how to apportion holding costs (and other expenditure) in this situation, see *QB 19/05: What are my income tax obligations if I rent out my home or a separate dwelling on my property as short-stay accommodation?* (Inland Revenue, May 2019).

148. If there is no current year income but there is anticipated income-earning use of the property (for example, the property is advertised as available for rent, but is not actually rented during the year), the nexus requirement in s DA 1 may be satisfied (see [91]), allowing holding costs to be deducted for those periods. In this scenario, the interest limitation rules in subpart DH (see [124]) need to be considered in respect of interest. Any interest denied under subpart DH may become deductible on taxable sale of the land (see from [172]).

149. If land is held on capital account but ends up being taxed on sale (for example, under the bright-line test), this does not generally alter the approach to apportionment of holding costs. As discussed from [82], land that is held on capital account is not committed to an income-earning activity of taxable sale during the period of ownership, though it may transpire that the sale ends up being taxed. As such, the fact the property ends up being taxed on sale is not factored into the apportionment of holding cost expenditure – it does not alter what it was that the taxpayer was seeking

[23] Noting that the interest limitation rules may mean some or all interest is not deductible.

to gain from incurring the expenditure. And as noted at [88], the requirements for deductibility are tested at the time expenditure is incurred.

150. However, the approach to apportionment of holding costs would differ for any period of the taxpayer's ownership it can be shown there was a genuine and reasonable expectation that the sale would be taxed (see from [92]). If there is any private use of the property during this period, the Commissioner would accept a 50:50 apportionment as a starting point, and full deductibility for any time in this period there is no private use. But if either the income-earning use or the private use were more dominant or important, this apportionment should be adjusted to reflect that.

The interest limitation rules

151. The interest limitation rules noted at [124] have been introduced since the publication of QB 19/08 and QB 19/05. These rules mean interest deductions for many residential properties will no longer be available (though it is noted that these rules do not apply to the extent land is a person's main home). Interest may therefore need to be considered separately from other holding cost expenditure.

152. Interest deductions that would have been allowed if not for the interest limitation rules in subpart DH may become deductible if the land is sold and the sale is taxed (s DH 11). See further from [172]. This means that (appropriately apportioned) interest deductions that have been denied only because of the rules in subpart DH may become deductible if land held on capital account ends up being taxed on sale (for example, under the bright-line test). But the taxable sale of land held on capital account will not alter the apportionment – that is, the fact that the sale has been taxed is not relevant to the apportionment between income-earning and private use, so has no bearing on the amount of interest that may become deductible on taxable sale. Nor will the fact the land ends up being taxed on sale alter the apportionment of other holding costs (for example, rates and insurance) that have been deductible – that is, the fact that it transpires that the sale is taxed will not allow a greater proportion of those costs to be deducted.

The ring-fencing rules

153. There is another set of rules that have been introduced since the publication of QB 19/08 and QB 19/05 – the ring-fencing rules in subpart EL. The ring-fencing rules limit the deductions that can be taken in any year that deductions for residential property exceed income from the property (or a portfolio of properties that the taxpayer owns). If allowable deductions exceed income from the property (or portfolio), the excess amount (over the amount of income) is carried forward for use in a future year where income is earned from the property or portfolio.

154. QB 19/08 and QB 19/05 should be read subject to the interest limitation rules in subpart DH and the ring-fencing rules in subpart EL.

If the mixed-use asset rules are opted out of

155. As noted at [116], a taxpayer can opt out of the MUA rules for an asset that would otherwise be in the rules in two situations. If a person opts out of the MUA rules, the income from the use of the asset is exempt income (s DG 21).

156. As noted at [115], use is defined in the MUA rules as "the active use of the asset for its intended purpose". This means only income from the active use of the asset (for example, rental) is exempt income. Any income from the sale of land (that is, if one of the land sale rules applies) is not exempt income.

157. Section DA 2(3) provides that a person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving exempt income.

158. If the land is held on capital account and is not sold in the year, the person cannot deduct any expenses for the property for that year. This is because all the expenses have been incurred in deriving only exempt income (s DA 2(3)).

159. If the land is held on capital account and is sold in the income year with the sale being taxed, the consequences are as follows:

- Interest deductions that have been disallowed during the period of ownership only by subpart DH (for example, in years the MUA rules were not opted out of) may be able to be deducted in the year of sale (see [174]).
- Holding costs other than interest incurred in any year the MUA rules were opted out of are not deductible because they were incurred in deriving only exempt income. This is not altered by the fact the sale of the property subsequently ends up being taxed – the nexus test between these costs and the income on sale would not have been met at the relevant time (when the expenses were incurred). The exception to this is holding costs incurred in any period there was a genuine and reasonable expectation the sale would be taxed.
- The deductibility of holding costs other than interest incurred in any year the MUA rules were not opted out of does not change. That is, the apportionment of those costs is not affected by the fact the sale of the property ends up being taxed.
- The cost of the property is deductible under s DB 23.

160. If a taxpayer has opted out of applying the MUA rules to land held on revenue account, holding costs are deductible subject to appropriate apportionment. This is because one of the uses of the land is that it is being held for taxable sale, so there is a sufficient nexus between the expenditure and the derivation of income from the taxpayer's income-earning process. However, apportionment is required because the property is also used to derive exempt income and used privately. The discussion on

apportionment from [131] is relevant in this scenario, although the additional use of deriving exempt income also needs to be factored in.

Whether holding costs are part of the cost of the property, so deductible on taxable sale

161. The final issue for consideration is whether holding costs for land that is taxed on sale form part of the cost of the land, in which case they may be deductible under s DB 23. This is relevant to:

- the ability to deduct holding costs for land held on capital account that is not used to derive current year (or anticipated) income;
- the timing of deductions; and
- whether holding costs need to be apportioned on account of private use of the property.

162. Section DB 23 provides:

> **DB 23 Cost of revenue account property**
>
> *Deduction*
>
> (1) A person is allowed a deduction for expenditure that they incur as the cost of revenue account property.
>
> …
>
> *Link with subpart DA*
>
> (3) Subsection (1) supplements the general permission and overrides the capital limitation and the private limitation. Subsection (2) overrides the general permission. The other general limitations still apply.

163. Section EA 2 provides:

> **EA 2 Other revenue account property**
>
> *When this section applies*
>
> (1) This section applies to revenue account property that is not—
>
> (a) trading stock valued under subpart EB (Valuation of trading stock (including dealer's livestock)):
>
> …
>
> *Timing of deduction*

> (2) A deduction for the cost of revenue account property of a person is allocated to the earlier of—
>
> (a) the income year in which the person disposes of the property; and
>
> (b) the income year in which the property ceases to exist.

164. Section EA 2 applies to land, as land is excluded from the definition of "trading stock" (s EB 2(3)(a)). Therefore, if holding cost expenditure forms part of the cost of land and the land is taxed on sale, the deduction (to the extent it is allowed) would be taken in the year of sale rather than in the year the expenditure is incurred.

165. The issue of whether holding costs form part of the cost of land is also relevant to the ability to deduct holding costs for land that is not used to derive current year (or anticipated) income, but that ends up being taxed on sale (for example, under the bright-line test). This is because s DB 23(1) supplements the general permission. Section DA 3(1) provides that if a provision supplements the general permission, the general permission does not need to be satisfied for the deduction to be allowed.

166. Section DB 23(1) also overrides the private limitation. This means that if holding costs form part of the cost of land, that expenditure would not need to be apportioned on account of private use of the property if the property is taxed on sale.

Meaning of "cost"

167. The Act does not define "cost" for the purposes of s DB 23. However, its meaning has been considered in numerous cases.[24]

168. The case law has established that:

- the word cost is capable of various meanings, depending on the context,
- cost means that which must be given in order to acquire something and has a wider meaning than payment on purchase, and
- in determining cost, a transaction must be viewed in its commercial reality, and some assistance may be derived from common business parlance and practice, including accepted accounting practice.

169. The Commissioner considers that, generally, the meaning of "cost" of revenue account property in s DB 23 is the commonly understood meaning of the term, being that

[24] Including *Tasman Forestry Ltd v CIR* (1999) 19 NZTC 15,147 (CA), *CIR v Atlas Copco (NZ) Ltd* (1990) 12 NZTC 7,327 (HC), *PM Scientific Fur Cleaners Ltd v Home Insurance Co* (1970) 12 DLR (3d) 177 and *BP Refinery (Kwinana) Ltd v Federal Commissioner of Taxation* (1960) 12 ATD 204 (HCA).

which is given to acquire something. For land, this includes the initial outlay to acquire the land as well as the cost of capital improvements, as these form part of the land.

170. The Commissioner does not consider that holding costs for land can generally[25] be considered to be part of the cost of the land. They are expenses incurred in relation to the ownership of land not its acquisition.

171. Therefore, as with any other deductions not subject to a specific timing provision, if holding costs are deductible they are (generally) deductible as incurred. As already discussed, deductibility depends on there being the requisite nexus with income (including anticipated income), and is subject to any required apportionment, the general limitations, the interest limitation rules and the ring-fencing rules.

Taxable sale of land – treatment of interest deductions disallowed by subpart DH, and the ring-fencing rules

172. If land is sold and the sale is taxed, interest deductions that would have been allowed during the ownership period if not for the interest limitation rules in subpart DH may become deductible (s DH 11).

173. However, the extent to which reinstated interest deductions or other deductions for the property can be allocated to the income year of sale may require consideration of the ring-fencing rules or the bright-line loss quarantine rule.

174. As explained below, the way the rules work depends on:

- whether the sale is taxed under the bright-line test or under one of the other land sale provisions, and
- how the ring-fencing rules have been applied (that is, whether to that property alone or to a portfolio of properties, and whether excess deductions have been transferred to the property or portfolio from another property or portfolio).

[25] But see, for example, the legislative exception to this that may apply for interest deductions denied by the interest limitation rules, if the sale of the property is taxed under the bright-line test (discussed from [175]). Also, there may be circumstances where, for a period, some holding costs are capitalised for accounting purposes (see, for example, New Zealand Accounting Standards Board NZ IAS 23: *Accounting treatment for borrowing costs* (July 2007, incorporating amendments to 28 February 2018)). That may be a relevant consideration in terms of whether those costs should also be regarded as part of the cost of the asset for tax purposes.

Previously denied interest deductions if the sale is taxed under the bright-line test

175. The amount of interest that would have been deductible in each year the property was owned **but for subpart DH**, is treated as part of the cost of the land for the purposes of s DB 23.

176. This means those deductions will become deductible on the taxable bright-line sale, subject to:

    - the cost of the land (so the allowable deduction) needing to be reduced because there has been some main home use of the property (there is a formula for this in s DB 23C), and
    - the bright-line loss quarantine rule in s EL 20.

177. For land in the 10-year bright-line test (or 5-year new build bright-line test), the amount of income from the sale is reduced (under s CB 6A(8)) if there has been some main home use of the land but the main home exclusion from the bright-line test (s CB 16A) is not available. This ensures the sale is not taxed to the extent the land was used as the taxpayer's main home. Section DB 23C correspondingly reduces the person's cost deduction to reflect that some of the cost of the property relates to the untaxed main home use.

178. For land in the old 5-year bright-line test (s CZ 39), there is no reduction for main home use of the land – the main home exclusion applies either in full or not at all.

179. The bright-line loss quarantine rule in s EL 20 applies if the property is sold at a loss. If this is the case, the deduction for the cost of the land that is allowed in the year of sale is limited to the person's land sale income. The effect of this is that the loss on the sale of the property does not reduce the person's taxable income (for example, if they have other income such as salary or business income). Any excess cost deductions that cannot be taken in the year of sale are carried forward and may be used against land sale income in the future.

Previously denied interest deductions if the sale is taxed under a provision other than the bright-line test

180. The amount of interest that would have been deductible **but for subpart DH** is allowed under s DH 11 as a deduction in the year of sale, but is subject to allocation under subpart EL (commonly known as the ring-fencing rules).

The ring-fencing rules in the year of taxable sale

181. In the year of taxable sale, there may be ring-fenced deductions for the property (or a portfolio it was part of) from previous years that have not yet been allocated to an income year. Those ring-fenced deductions and deductions for the current year[26] are added together and allocated in accordance with the ring-fencing rules.

182. The starting point is that of those total deductions, an amount up to the amount of income from the property (or portfolio) can be claimed that year. This includes any net profit from taxed land sales in the year.

183. If after that there are still deductions remaining (that is, the past and current year deductions exceed the income from the property or portfolio), there are special rules that may allow those excess deductions to be un-ring-fenced. The way those rules work depends on whether the ring-fencing rules have been applied to that property alone, or to a portfolio of residential properties, and whether any excess deductions have been transferred to the property from other properties (and if so, whether those properties were taxed on sale).

184. If the ring-fencing rules have been applied to that property alone, the remaining ring-fenced deductions for the property become un-ring-fenced (so are allocated to the income year of sale), except to the extent of any deductions that have been transferred to the property from another property that was not taxed on sale. Any such transferred deductions remain subject to the ring-fencing rules and are carried forward and may be used in a future year.

185. If the ring-fencing rules have been applied to a portfolio of residential properties the property sold in the year was part of, the remaining ring-fenced deductions for the portfolio may become un-ring-fenced only if the property sold in the year is the last property in the portfolio to be sold and all the sales have been taxed. If that is the case, the remaining ring-fenced deductions would be un-ring-fenced except to the extent of any deductions that have been transferred to the portfolio from another property that was not taxed on sale. Any such transferred deductions remain subject to the ring-fencing rules and are carried forward and may be used in a future year.

[26] Excluding interest deductions that become part of the land's cost, if the sale is taxed under the bright-line test.

Examples | Tauira

Example | Tauira 1 – Land held on revenue account and used privately

Note: this example only considers the deductibility of holding costs. Other approaches may be appropriate for any other deductible expenses.

Geraldine purchased an apartment in Wellington to use when she is there for work (three to five days a week), with the intention of reselling it for profit when her two-year contract ends.

In the income year in question, the apartment is used by Geraldine for a total of 192 days.

The MUA rules do not apply because there is no income-earning use that is recognised under those rules. Income-earning use for the MUA rules is the active use of the asset for its intended purpose (for example, rental use of the apartment would qualify, but Geraldine does not rent the apartment out).

For the whole year, the apartment is committed to an income-earning process, being held on revenue account (that is, for taxable sale). While this is not an income-earning use for the MUA rules, it is income-earning use in terms of satisfying the deductibility test.

The apartment is also considered to be used privately for the whole year, not just on the 192 days Geraldine was there. The apartment is being held and maintained essentially as a second home and normal use of a home (or second home) includes periods of absence.

Therefore, for the whole income-year there is simultaneous income-earning use (because the property is held on revenue account) and private use of the apartment. Geraldine considers that a 50:50 apportionment of holding costs is most appropriate. On this basis, any deductible holding costs will be 50% deductible.

The Commissioner would accept this basis for apportionment of Geraldine's holding cost expenditure. A taxpayer could apportion holding costs in other ways, depending on their particular circumstances. The important thing is that the method chosen represents a fair and reasonable weighing up of the relative importance of the income-earning and private uses.

Geraldine must apply the interest limitation rules in subpart DH to determine whether any interest she has incurred for the apartment is deductible (subject to the above apportionment).

The ring-fencing rules in subpart EL will not apply to limit the amount of deductions that can be claimed in this year if Geraldine has notified the Commissioner that the property is held on revenue account (see s EL 10(2) and (3)). But if she has not done this, the ring-fencing rules will need to be considered. If the ring-fencing rules apply and Geraldine's allowable deductions for the property (or a portfolio of properties) exceed income from the property (or portfolio) for the year, the rules will limit the amount of deductions that can be claimed in this year (with the excess being carried forward).

Any interest Geraldine would have been allowed to deduct (after appropriate apportionment on account of the private use of the property) were it not disallowed by the interest limitation rules will become deductible in the year Geraldine sells the apartment because the sale is taxed. This deduction[27] is subject to allocation under the ring-fencing rules.[28]

Example | Tauira 2 – Land held on capital account, used privately and for rental, and taxed on sale under the bright-line test

Note: this example only considers the deductibility of holding costs. Other approaches may be appropriate for any other deductible expenses.

Jonathan owns a property in Queenstown that he rents out to tourists and also uses occasionally himself.

Year one:

In the first income year Jonathan owns the property, it is rented out for 315 days and used by Jonathan for 5 days. The property is vacant for 45 days. Jonathan had the booking calendar for 10 of the vacant days blocked out, as he was hoping to be able to make it to Queenstown in that period. The property was listed as available for rent at market rates for the other 35 days it was vacant.

The property was vacant for less than 62 days, so the MUA rules do not apply for this income year.

Jonathan must apply the interest limitation rules in subpart DH to determine whether any interest he has incurred for the property is deductible.

[27] Plus any other deductions (other than the deduction for the (capital) cost of the property) Geraldine may have for the property (or portfolio) for the year.

[28] Which would be relevant if the property was part of a not-fully-taxed portfolio or if any excess deductions had been transferred to the property from another property that was not taxed on sale.

Any deductible interest and other holding costs are 100% deductible for the 315 days of the year the property was rented out and 35 of the 45 days it is vacant – when it was listed as available for rent at market rates. The only use of the property during those times is income-earning, as it is being used in an income-earning process (to earn rental income). The property is not considered to also be used privately in the vacant period that it is available for rent. Therefore, no apportionment is required for this period.

For the period of 10 days that the property is vacant and not available for rental (when the booking calendar is blocked) and the period of 5 days Jonathan uses the property, no holding costs are deductible. The property is not being used in an income-earning process in these periods.

If Jonathan's allowable deductions for the property (or a portfolio of properties) exceed income from the property (or portfolio) for the year, the ring-fencing rules in subpart EL may apply to limit the amount of deduction that can be claimed in this year (with any excess being carried forward). The ring-fencing rules will be relevant this income year because the property is not a MUA (see s EL 12).

Year four:

In the fourth year Jonathan owns the property, it is used or available for rent at all times and is not used by Jonathan. He sells the property a few months into the income year. The sale is taxed under the bright-line test.

Jonathan cannot deduct any additional amount of holding costs from the years he owned the property by virtue of the sale of the property being taxed.

However, any interest that Jonathan would have been allowed to deduct (after appropriate apportionment in each year he owned the property) were it not disallowed by the interest limitation rules will become deductible in the year Jonathan sells the property because the sale is taxed. Because the sale is taxed under the bright-line test, any interest that becomes deductible in the year of sale under these rules is added to the cost of the property. Provided the amount of income from the sale is more than the total cost of the property, the full cost deduction can be claimed that year.

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