INTERPRETATION STATEMENT | PUTANGA WHAKAMĀORI

Income tax – implications of a residential property moving between the standard tax rules and the mixed-use asset rules

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IS 25/08

This interpretation statement considers situations where a person's use of their residential property has changed so the property moves from being under one set of income tax deduction rules to another. It explains how a person determines which income tax deduction rules apply and the consequences of moving between the standard tax rules and the mixed-use asset rules.

All legislative references are to the Income Tax Act 2007.

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Summary | Whakarāpopoto

1. This interpretation statement explains how a person determines:
   - which income tax deduction rules apply to their residential property when its use has changed from the prior income year;
   - the effect of a change in income tax deduction rules on a person's ability to use prior year quarantined expenditure under the mixed-use asset rules;
   - the effect of a change in income tax deduction rules on a person's ability to claim prior year unused excess deductions under the residential property ring-fencing rules; and
   - how the depreciation rules apply to depreciable property used in a residential property when there has been a change in which set of income tax deduction rules apply to the property.
2. This statement applies to persons who derive income from their residential property. This statement does not apply to residential property owned by companies (including close companies).

Income tax deduction rules

3. If a person derives income from a residential property, they must determine whether the mixed-use asset rules or the standard tax rules apply to that property. If the use of a residential property changes from one income year to the next, or within an income year, the set of income tax deduction rules that applies to the residential property may be different from the set of rules that applied in previous income years.
4. The set of rules that applies determines the deductible proportion of the person's expenses. The person must consider which income tax deduction rules apply each income year because the mixed-use asset and residential property ring-fencing rules apply on an income year basis.
5. A person must apply the mixed-use asset rules if, during the income year, the residential property was:
   - partly used to earn income;
   - partly used for private use; and

- unused for at least 62 days.

6. If the residential property is not a mixed-use asset, the standard tax rules apply. In addition, a person must consider if the residential property is subject to the residential property ring-fencing rules.

Amount of deduction may be limited

7. The amount of the deduction a person can claim relating to their residential property may be limited.

8. If the mixed-use asset rules apply, the amount of the person's deduction is apportioned in the current income year for the private use of the residential property. Further, the amount of the deduction that can be claimed in the income year may be limited under the mixed-use asset quarantined expenditure rules.

9. A person cannot offset any expenditure incurred in a prior income year that has been quarantined under the mixed-use asset rules if the residential property is not a mixed-use asset in the current income year. If the person has not sold the residential property, they can carry forward the quarantined expenditure to future income years.

10. If the standard tax rules apply, a person must consider whether the residential property ring-fencing rules limit the amount of the deduction that can be claimed in the income year. The residential property ring-fencing rules do not apply if one of the specific exclusions applies (for example, the main home exclusion or the mixed-use asset exclusion).

11. A person cannot offset any unused excess deductions carried forward from a prior income year under the residential property ring-fencing rules if their residential property is not subject to the residential property ring-fencing rules in the current income year. However, a person can carry forward the unused excess deductions to future income years.

Calculating depreciation deductions

12. A person can claim depreciation deductions in relation to depreciable property that they use to derive income from their residential property.

13. The first step to calculate a deprecation deduction is for a person to calculate their depreciation loss for the income year for each item of depreciable property. The next step is to work out what proportion of the depreciation loss the person can claim as a deduction in the income year.

14. The proportion of the depreciation loss that is deductible depends on which income tax deduction rules apply to the residential property in the income year and whether the depreciable property is wholly or partly used to produce income.

15. If the mixed-use asset rules apply to the residential property in a given income year, the person must use the apportionment formula in s DG 9 to calculate their depreciation deduction. Further, part of the depreciation deduction may be suspended if the quarantined expenditure rules apply.

16. If the standard tax rules apply and the depreciable property is wholly used to produce income, the depreciation deduction is the depreciation loss amount. However, if the depreciable property is only partly used to produce income, the person must apportion the depreciation loss. In addition, if the residential property ring-fencing rules apply, the person may need to suspend a portion of the depreciation deduction and carry it forward to a future income year.

17. Any apportionment of the depreciation loss under either the standard tax rules or the mixed-use asset rules does not change how a person calculates the depreciation loss in future income years. The calculation for the depreciation loss is based on the depreciable property's adjusted tax value, which takes into account the total depreciable loss a person could have claimed before any apportionment or suspension.

Disposal of depreciable property

18. When a person sells an item of depreciable property, they must calculate their depreciation recovery income or depreciation loss on sale. The method for calculating depreciation recovery income or depreciation loss on sale is the same whether the standard tax rules or mixed-use asset rules apply to the residential property.

19. A person cannot offset any prior-year mixed-use asset quarantined expenditure against depreciation recovery income. Depreciation recovery income is not asset income (that is, income derived from the use of the mixed-use asset).

20. If the residential property ring-fencing rules apply to the residential property in the income year an item of depreciable property is sold, a person can offset unused excess deductions against depreciation recovery income they derive on the sale of the item of depreciable property. However, if the residential property ring-fencing rules do not apply in the income year of sale, a person cannot offset unused excess deductions against depreciation recovery income.

Introduction | Whakataki

21. If a person derives rental income from a residential property, they must work out which income tax deduction rules apply so they can meet their tax obligations.

22. Depending on a person's circumstances, the residential property will fall under either the mixed-use asset rules or the standard tax rules. The set of rules that applies determines the deductible proportion of the person's expenses and how any unused deductions can be used in future income years.

23. A person also needs to consider whether they can claim depreciation deductions for the use of items of depreciable property used in conjunction with the residential property. How the rules apply can become complicated when a person has calculated depreciation deductions under the mixed-use asset rules in one income year and under the standard tax rules in the next income year, or the other way around.

24. This interpretation statement provides guidance for persons who derive income from residential property and the use of that residential property changes. This interpretation statement is organised into four parts:

   - **Part one** – explains how a person determines which income tax deduction rules apply to their residential property.
   - **Part two** – discusses when a person can use prior-year expenditure that has been quarantined under the mixed-use asset rules, or unused excess deductions carried forward from a prior income year under the residential property ring-fencing rules.
   - **Part three** – discusses how to apportion the depreciation loss and calculate the depreciation deduction when the residential property moves from being under one set of income tax deduction rules to another.
   - **Part four** – explains how to calculate depreciation recovery income or depreciation loss on sale on the disposal of depreciable property.

Part one – Determining which income tax deduction rules apply

25. If a person derives rental income from a residential property, they must determine whether the mixed-use asset rules or the standard tax rules apply.

26. If the use of the residential property changes in an income year, the income tax deduction rules the person must apply to the property for that income year may differ from the set of rules they applied to it in the previous income year.

27. A person must revisit which income tax deduction rules apply each income year, as the mixed-use asset rules apply on an income-year basis. A person must keep records to work out at the end of each income year which rules apply and to be able to apply the relevant rules correctly.

28. Figure | Hoahoa 1 will help a person determine which set of income tax deduction rules applies to their circumstances in any given income year.

Mixed-use asset rules

29. The mixed-use asset rules apply where assets are sometimes used privately, sometimes used to earn income and are also unused for at least 62 days during the income year. The mixed-use asset rules apply on an asset-by-asset basis. Residential property is within the scope of the mixed-use asset rules.

30. If the mixed-use asset rules apply, a person must use those rules to apportion their expenditure between the income earning use of the residential property and its private use. In addition, if the residential property is loss making, the person must determine whether any of their deduction is quarantined expenditure.

Asset criteria

31. Residential property is a "mixed-use asset" if, during the income year it (s DG 3):

- is partly used to earn income;
- is partly used privately; and
- was not used for at least 62 days.

32. Private use includes use by persons associated with the owner and use by persons renting it for "mates' rates" – that is, rates that are less than 80% of the market value rent (s DG 4). Further, it is not necessary for the private use to be exclusive use of the residential property for the mixed-use asset rules to apply.

33. If the residential property meets the criteria for a mixed-use asset, the owner must consider whether any of the exclusions to the mixed-use asset rules apply.

34. The mixed-use asset rules will not apply to residential property if its only income-earning use in the income year is as a long-term rental property (s DG 3(4)(c)).

35. A person can opt out of the mixed-use asset rules if (s DG 21):

- their income for the income year from the residential property is under $4,000;[1] or
- they made a loss from the residential property and if they did not opt out of the rules would have quarantined expenditure (that is, expenditure carried forward to the next income year).

36. If a person chooses to opt out of the mixed-use asset rules, the income from the residential property is exempt. This means the person does not pay tax on the income and they cannot claim tax deductions for any expenditure or loss relating to the residential property.

37. For further information on opting out of the mixed-use asset rules, see QB 25/02: **Income tax – Which rules apply if I have a dwelling I sometimes rent out as short-stay accommodation and also sometimes uses privately?**

Apportionment of expenditure

38. If the residential property is a mixed-use asset, deductions can be claimed for expenses that relate solely to its rental activity. Any expenses that relate solely to the private use of the residential property are not deductible.

39. Expenses that relate to both the income-earning and private use of the residential property will be only partly deductible. The person must use the formula in s DG 9(2) to calculate the deductible portion of this expenditure:

$$\text{expenditure} \times \text{income-earning days} \div (\text{income-earning days} + \text{counted days})$$

where:

- "expenditure" is the expenditure that relates to both the income-earning and private use of the residential property;
- "income-earning days" are the total number of days in the income year that the person derived income (other than exempt income) from the use of the mixed-use asset; and
- "counted days" are the total number of days in the income year the asset was in use, excluding income-earning days.

40. The effect of the formula is that the proportion of expenses that is deductible reflects the income-earning use of the mixed-use asset relative to the private use.

[1] The $4,000 threshold does not include income that is classed as exempt income. Exempt income is income from renting out the dwelling to associated persons (for example, family members) or income from renting out the dwelling for less than 80% of the market value rent.

41. For an explanation of how to determine the expenditure a person may deduct against their income from a mixed-use asset, see QB 25/03: **Income tax – How do the mixed-use asset rules apply if I provide short-stay accommodation?**

Quarantined expenditure

42. If a person's residential property is a mixed-use asset and the person makes a loss from the rental activities, they must determine whether the quarantined expenditure rules apply (s DG 16).

43. The expenditure quarantine rules apply to a mixed-use asset if:

- income derived from the use of the asset (other than exempt income) during the income year is less than 2% of the mixed-use asset's value; and
- the person incurs expenditure for the income year.

44. For more detailed guidance on when the quarantined expenditure rules apply, see QB 25/03.

45. If the quarantined expenditure rules apply, the person may only deduct their expenses up to the amount of rental income they received from the mixed-use asset. A person cannot offset the amount of the expenses over and above the amount of asset income against their income from other sources (for example, salary and wage income). Instead, that amount of expenses is quarantined and carried forward to a future income year. The discussion from [62] explains how a person can use quarantined expenditure in future income years.

Standard tax rules

46. If a person derives income from a residential property during the income year and the property is not within the scope of the mixed-use asset rules, they must apply the standard tax rules to calculate their taxable income.

47. Any income a person receives from renting a residential property is generally taxable income (s CC 1). A person must determine what deductions they can claim for expenditure incurred in deriving the rental income (s DA 1).

48. The starting point is that a person can fully deduct expenses that relate solely to their rental activity.[2] Conversely, any expenses that relate solely to their private use of the property are non-deductible.

[2] However, interest may not be fully deductible until 1 April 2025. Further, if the dwelling is rented through an online marketplace, the person may need to claim their deduction on a GST-exclusive basis (as QB 25/04 explains).

49. To the extent an expense relates to both a person's income-earning and private use of the property, it will be only partly deductible.

50. For further information on how to apply the standard rules, see QB 25/04: **Income tax – How do the standard tax rules apply if I provide short-stay accommodation?** and QB 23/08: **Income tax – deductibility of expenditure – renting to flatmates**.

51. If the standard tax rules apply to the residential property, a person must also consider whether the residential property ring-fencing rules apply.

Residential property ring-fencing rules

52. The residential property ring-fencing rules may apply when a person owns a residential property and has expenditure or a loss that relates to the property for which they are allowed a deduction.

53. The residential property ring-fencing rules operate to prevent a person from offsetting deductions incurred for residential properties against other sources of income (for example, salary or wages). This means if the person's rental activity makes a loss (that is, the deductible expenses exceed the income), they cannot claim the excess deductions (that is, the extent to which they exceed the income) in that income year (s EL 4). Any excess deductions are not permanently forfeited but are suspended and may be offset against future income derived from residential property. The discussion from [67] explains how a person can use the unused excess deductions in future income years.

54. There are several exclusions from the residential property ring-fencing rules (see ss EL 9 to EL 13), including exclusions for a main home and for mixed-use assets.

Main home exclusion

55. The main home exclusion (s EL 9) applies if:

- more than 50% of the land is used as the person's main home (the space threshold); and
- the person uses the land as their main home for more than 50% of the income year (the time threshold).

56. A "main home" is the one dwelling that a person mainly uses as a residence (s YA 1). In determining what a person's main home is, if they have more than one home, the focus is on the nature of the place and the relationship between the person and that place – see QB 24/01: **If a person has two or more homes, which home is their main home for the purpose of the main home exclusion to the bright-line test?**

57. The main home exclusion can apply if a trust owns the residential property, provided:

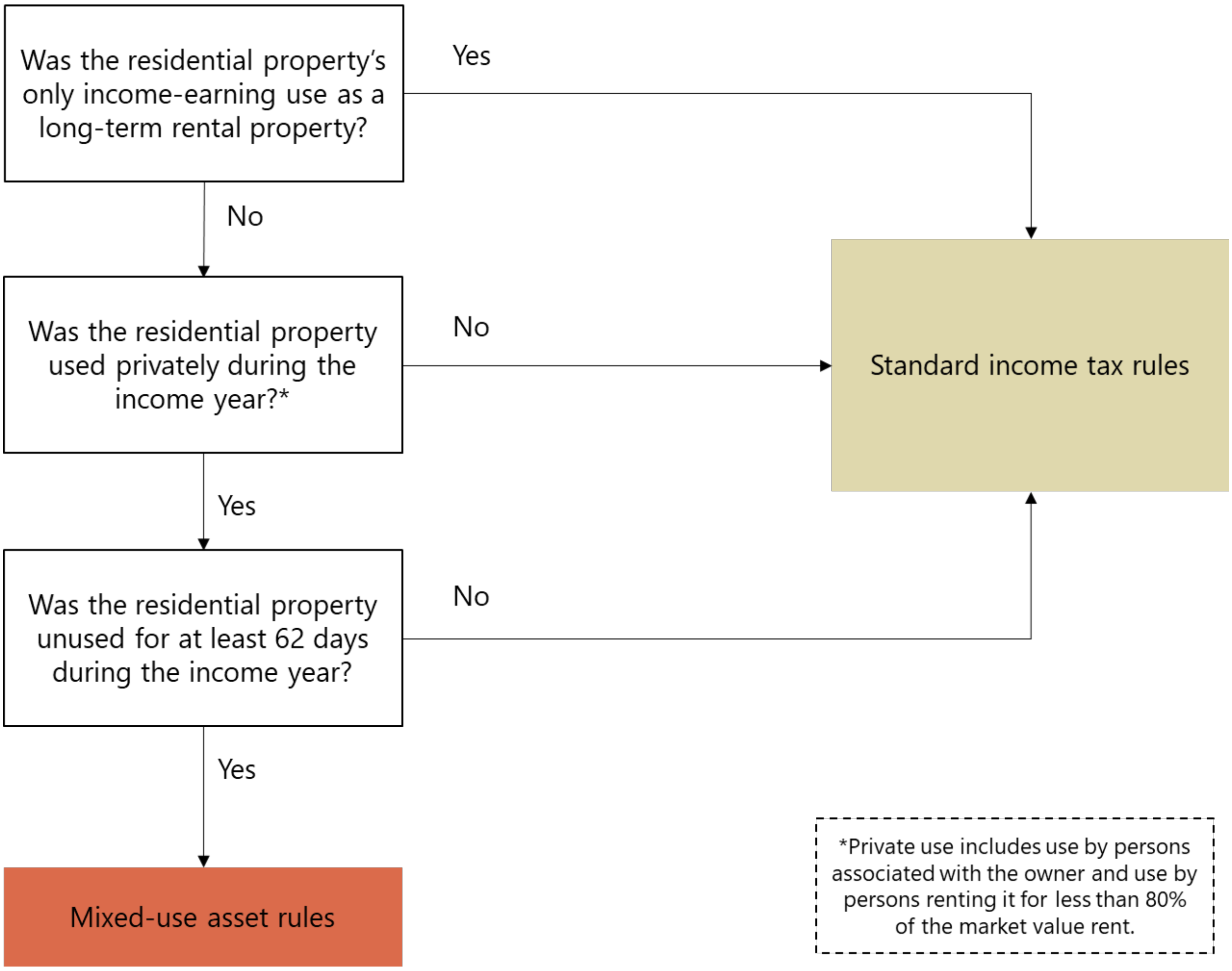
- a beneficiary of the trust occupies the property as their main home; and
- either the principal settlor of the trust does not have a main home or, if they do, it is the property in question.

Mixed-use asset exclusion

58. The residential property ring-fencing rules do not apply to residential land for an income year when the land is an asset within the scope of the mixed-use asset rules (s EL 12).

59. Figure | Hoahoa 1, Example | Tauira 1 and Example | Tauira 2 provide guidance on how a person can work out which income tax deduction rules apply to their residential property.

Figure | Hoahoa 1 – Determining which income tax deduction rules apply to residential property you earn income from



Example | Tauira 1 – A property changing from being the owner's residence to a long-term residential rental

Anaru owns a three-bedroom property in Taupō. After he purchased the property in 2021, Anaru lived in the property with two flatmates. In the 2023–24 income year (the income year ending 31 March 2024), he receives a promotion from his employer and moves to Napier to take up the new role. Anaru moves out of the Taupō property on 15 January 2024. Anaru's flatmates continue to live in the property under a tenancy arrangement.

Anaru's deductions for the Taupō property are not ring-fenced in the 2023–24 income year as the main home exclusion applies. Anaru has used the entire Taupō property as his main home for more than 50% of the income year.

The mixed-use asset rules do not apply to the Taupō property for the 2023–24 income year as the property was not unused for 62 or more days during the income year; it was used for the whole income year.

Anaru must apply the standard tax rules to work out his tax obligations in relation to the property for the 2023–24 income year (see QB 23/08).

Example | Tauira 2 – A property changing from being a mixed-use asset to a long-term residential rental

Susie owns a three-bedroom property in Dunedin. For the first 4 months of the 2021–22 income year, Susie lives in the property and lets one of the bedrooms as short-stay accommodation. Susie lets the bedroom at a market rent, and it has approximately 60% occupancy during those 4 months.

In August 2021, Susie moves back to her parents' home and her Dunedin property is left vacant. In November 2021, Susie decides to rent her Dunedin property to long-term tenants.

During the 2021–22 income year, Susie has used the Dunedin property privately (as her residence) and has used it to derive income (rental income). The Dunedin property was also vacant for more than 62 days during the income year.

The Dunedin property will be in the mixed-use asset rules for the income year unless one of the asset exclusions applies.

An asset is excluded from the mixed-use asset rules if it is a residential property and the **only** income-earning use is as a long-term rental property. Susie has earned income from the Dunedin property from short-stay accommodation and long-term rental during the 2021–22 income year. Therefore, the long-term rental exclusion does not apply, as long-term rental income was not the sole source of Susie's income from the Dunedin property for the income year.

As the Dunedin property is a mixed-use asset, the residential property ring-fencing rules do not apply due to the mixed-use asset exclusion from the ring-fencing rules. Instead, the mixed-use asset rules will apply to the Dunedin property.

For completeness, the main home exclusion from the residential property ring fencing rules will not apply as Susie has not used the Dunedin property as her main home for more than 50% of the 2021-22 income year. The Dunedin property was Susie's main home for only 4 months of the 2021-22 income year.

Susie must apply the mixed-use asset rules to calculate her deductible expenditure for the Dunedin property for the 2021–22 income year (see QB 25/03).

In the 2022–23 income year, Susie continues to live at her parents' home and rent the Dunedin property as a long-term rental. The standard tax rules apply to the Dunedin property in the 2022–23 income year, because the long-term rental exclusion from the mixed-use asset rules applies.

In the 2022–23 income year, the Dunedin property is subject to the residential property ring-fencing rules as neither the main home exclusion nor the mixed-use asset exclusion from the ring-fencing rules applies.

Part two – Prior year quarantined expenditure or unused excess deductions

60. In some cases where a residential property has made a loss, a person may have either:
    - quarantined expenditure under the mixed-use asset rules (see from [62]); or
    - unused excess deductions under the residential property ring-fencing rules (see from [67].

61. The person must determine whether they can offset the quarantined expenditure or unused excess deductions suspended from prior income years against their current year income.

Offsetting prior year mixed-use asset quarantined expenditure against current year income

62. Mixed-use asset quarantined expenditure carried forward from a prior income year may be offset against "asset income" in the current income year (s DG 17).

Asset income

63. "Asset income" is the total amount of taxable income derived in the current income year from the use of the asset. The mixed-use asset rules define "asset". Residential property will be an "asset" for the mixed-use asset rules if it meets specific criteria, including criteria relating to the use of the asset – see [31].

64. If the residential property has previously been in the mixed-use asset rules but does not meet the criteria of an asset in the current income year because the use of the asset has changed, the owner will not derive any asset income. Therefore, the owner will not be able to use quarantined expenditure carried forward from a prior income year in the current income year. This is illustrated in Example | Tauira 3.

65. The quarantined expenditure continues to be carried forward to future income years. The person may offset it against income in a future income year when the residential property is a mixed-use asset, and they derive asset income from the residential property.

66. Generally, quarantined expenditure from a mixed-use asset cannot be used against any income derived from a different mixed-use asset. If the mixed-use asset with quarantined expenditure is sold, any prior-year quarantined expenditure that cannot be deducted in the income year of sale is forfeited. However, quarantined expenditure can be offset against the asset income derived from a different mixed-use asset if (s DG 17(6)):

- the first asset is damaged or lost; and
- the second asset is acquired to replace the first asset; and
- the two assets are identical or substantially the same.

Example | Tauira 3 – Claiming deductions for prior-year quarantined expenditure

Following on from Example | Tauira 2, in the 2021–22 income year Susie made a loss from her Dunedin property and had quarantined expenditure under the mixed-use asset rules. Susie did not opt out of the mixed-use asset rules in the 2021–22 income year.

In the 2022–23 income year, Susie is unable to claim a deduction for the quarantined expenditure from the 2021–22 income year and any other prior income year, as the Dunedin property is no longer a mixed-use asset and Susie does not derive any "asset income" in the income year.

The mixed-use asset quarantined expenditure for the 2021–22 income year and any other prior income year will be carried forward. It will be available for Susie to deduct in a future income year if the Dunedin property becomes a mixed-use asset again.

Offsetting unused excess deductions against current year income

67. If residential property is subject to the residential property ring-fencing rules in an income year, a person will have unused excess deductions if their deductible expenditure exceeds their "residential income".

68. A person cannot offset the unused excess deductions against their income from other sources (for example, salary and wage income).

69. Unused excess deductions are carried forward to future income years and can be offset against future residential income the person derives from their residential property or portfolio.

70. What happens to any unused excess deductions if a residential property is sold depends on:

- whether the residential property ring-fencing rules were applied to a portfolio of properties or on a property-by-property basis; and
- whether the residential property or portfolio was fully taxed on sale – see IS 23/10: **Deductibility of holding costs for land**.

Residential income

71. "Residential income" is defined for the purposes of the residential property ring-fencing rules (s EL 3). In general terms, "residential income" includes rental income and

any depreciation recovery income a person derives in relation to their "residential portfolio" or individual property that is subject to s EL 4.

72. The default position is that the residential property ring-fencing rules apply on a portfolio basis. However, a person can elect to apply the rules on a property-by-property basis instead.

Residential portfolio

73. Unless a person has elected to apply the residential property ring-fencing rules on a property-by-property basis, their residential portfolio will consist of all residential rental properties they have included in their residential portfolio. The portfolio basis allows a person to calculate their total profit or loss across all residential properties in their portfolio that are subject to deductions being allocated under s EL 4 in that income year. The income from all properties in the portfolio subject to s EL 4 is offset, up to the amount of income from the portfolio, by deductions from all properties in the portfolio subject to s EL 4.

74. If a person has included a residential property in their portfolio at any time, it will remain part of their residential portfolio even if in a subsequent income year an exclusion (for example, the main home exclusion or the mixed-use asset exclusion) applies. The exclusions do not stop the residential property from being part of the person's residential portfolio. This is relevant in the income year the person sells the last of the properties in their residential portfolio. However, if an exclusion applies for a particular income year, s EL 4 does not apply to limit deductions for that income year for that property.

75. Despite a residential property remaining part of a person's residential portfolio if it has been included in the portfolio at any time, if the residential property is excluded from the s EL 4 limitation in a particular income year, neither the income nor the deductions for the property for that income year are taken into account for the purposes of applying s EL 4 to the properties in the person's portfolio that are not excluded. This has the effect that the person cannot offset:

- deductions for expenditure incurred relating to other properties in their residential portfolio against income from the excluded property; or
- any carried forward unused excess deductions relating to the residential portfolio against income from the excluded property.

76. A person will be able to carry forward the unused excess deductions to future income years. This is illustrated in Example | Tauira 4.

Property-by-property basis

77. The same principles for offsetting excess deductions apply if a person has elected to apply the residential property ring-fencing rules on a property-by-property basis. This is illustrated in Example | Tauira 5.

78. If a person has chosen to apply the rules on a property-by-property basis, the residential income they derive, along with the expenditure or loss, must relate solely to that individual property (property A). Any excess amount in relation to property A is suspended as a deduction and carried forward to a later income year in which the person derives residential income from property A (s EL 6).

Example | Tauira 4 – Offsetting unused excess deductions – portfolio basis

Rohan owns three residential properties. All three residential properties have been rented to tenants on a long-term basis. The residential properties have been subject to the residential property ring-fencing rules.

Rohan applies the residential property ring-fencing rules on a portfolio basis.

2021–22 income year

In the 2021–22 income year, Rohan's rental activity is as follows:

Residential portfolio	Residential income	Deductible expenditure	Expenditure deductible in the 2021–22 income year	Excess deductions carried forward to future income year
Property A	$16,500	$16,500		
Property B	$20,000	$19,000		
Property C	$5,000	$13,000		
Total	**$41,500**	**$48,500**	**$41,500**	**$7,000**

In the 2021–22 income year, Rohan can claim $41,500 of the expenses incurred for the properties in his portfolio. He has $7,000 of unused excess deductions to carry forward to the 2022–23 income year.

Rohan's tax summary for the 2021–22 income year is:

Taxable income $0

Excess deductions to carry forward $7,000

2022–23 income year

During the 2022–23 income year, the long-term tenants in Property C move out. Property C is unoccupied for a 3-month period and Rohan then lives in the property for a short time while his home is being renovated. Rohan then decides to let Property C as short-stay accommodation for the remainder of the income year. As a result of the change of use, Property C satisfies the mixed-use asset criteria in the 2022–23 income year.

For the 2022–23 income year, Rohan must apply the mixed-use asset rules, instead of the standard tax rules and the residential property ring-fencing rules, to determine his tax obligations relating to Property C. After calculating the deductions, he can claim for Property C under the mixed-use asset rules, Rohan calculates that his net income derived from Property C is $3,500.

In the 2022–23 income year, Rohan's rental activity from his residential portfolio is as follows:

Residential portfolio	**Residential income**	**Deductible expenditure**	**Expenditure deductible in the 2022–23 income year**	**Excess deductions carried forward to future income year**
Property A	$16,500	$15,500		
Property B	$20,000	$20,000		
Excess amounts carried forward from prior income year		$7,000		
Total	**$36,500**	**$42,500**	**$36,500**	**$6,000**

The excess amounts carried forward from the prior income year are added to the deductible expenses for the 2022–23 income year. The amount Rohan can claim in the 2022–23 income year is the greater of the total deductible expenses and the residential income from the portfolio for the income year. In this case, that means Rohan can claim $36,500 of the expenses and has $6,000 of unused excess deductions to carry forward to the 2023–24 income year. The effect of this is that Rohan has been able to offset $1,000 of the prior-year unused excess deductions against his residential income in the 2022–23 income year.

However, as Property C is a mixed-use asset and excluded from the s EL 4 limitation in the 2022–23 income year, Rohan is unable to offset any unused excess deductions against the income relating to Property C. Rohan is taxed on his net income from Property C of $3,500.

Rohan's tax summary for the 2022–23 income year is:

Taxable income $3,500

Excess deductions to carry forward $6,000

2023–24 income year

Rohan secures a long-term tenant for Property C in April 2023. Property C is not a mixed-use asset in the 2023–24 income year and is once again a residential property subject to the s EL 4 limitation in the residential property ring-fencing rules.

In the 2023–24 income year, Rohan's rental activity from his residential portfolio is as follows:

Residential portfolio	Residential income	Deductible expenditure	Expenditure deductible in the 2023–24 income year	Excess deductions carried forward to future income year
Property A	$16,500	$16,000		
Property B	$20,000	$22,000		
Property C	$15,000	$13,000		
Excess amounts carried forward from prior income year		$6,000		
Total	**$51,500**	**$57,000**	**$51,500**	**$5,500**

The excess amounts carried forward from the prior income year are added to the deductible expenses for the 2023–24 income year. The amount Rohan can claim in the 2023–24 income year is the greater of the total deductible expenses and the residential income from the portfolio for the income year. In this case, that means Rohan can claim $51,500 of the expenses and has $5,500 of unused excess deductions to carry forward to the 2024–25 income year. The effect of this is that Rohan has been able to offset $500 of the prior-year unused excess deductions against his residential income in the 2023–24 income year.

Rohan's tax summary for the 2023–24 income year is:

Taxable income	$0
Excess deductions to carry forward	$5,500

Example | Tauira 5 – Offsetting unused excess deductions – property-by-property basis

The same facts apply as in Example | Tauira 4, except that Rohan elects to apply the residential property ring-fencing rules to Property C on a property-by-property basis.

2021–22 income year

In the 2021–22 income year, Rohan's rental activity is as follows:

Residential portfolio	**Residential income**	**Deductible expenditure**	**Expenditure deductible in the 2021–22 income year**	**Excess deductions carried forward to future income year**
Property A	$16,500	$16,500		
Property B	$20,000	$19,000		
Total	**$36,500**	**$35,500**	**$35,500**	**$0**
Property-by-property basis				
Property C	$5,000	$13,000	$5,000	$8,000

Rohan has $8,000 of unused excess deductions to carry forward to the 2022–23 income year relating to Property C.

Rohan is able to claim the total $35,500 of expenses for his residential portfolio because the income from the portfolio exceeds that. Rohan therefore has net $1,000 of residential income from his residential portfolio.

Rohan's tax summary for the 2021–22 income year is:

Taxable income $1,000

Excess deductions to carry forward $8,000

2022–23 income year

In the 2022–23 income year, Rohan's rental activity from his residential portfolio is as follows:

Residential portfolio	**Residential income**	**Deductible expenditure**	**Expenditure deductible in the 2022–23 income year**	**Excess deductions carried forward to future income year**
Property A	$16,500	$15,500		
Property B	$20,000	$20,000		
Total	**$36,500**	**$35,500**	**$35,500**	**$0**

Rohan is able to claim the total $35,500 of expenses for his residential portfolio, as the income from the portfolio exceeds that. He therefore has net $1,000 of residential income from his residential portfolio.

Rohan's calculations of the deductions he can claim for Property C under the mixed-use asset rules show the net income he derived from Property C is $3,500. He is unable to offset any of the unused excess deductions relating to Property C that have been carried forward under the ring-fencing rules against the asset income derived in relation to Property C. Rohan is taxed on his net income from Property C of $3,500.

Rohan will have $8,000 of unused excess deductions to carry forward to the 2023–24 income year from Property C.

Rohan's tax summary for the 2022–23 income year is:

Taxable income $4,500

Excess deductions to carry forward $8,000

2023–24 income year

In the 2023–24 income year, Rohan's rental activity from his residential portfolio is as follows:

Residential portfolio	**Residential income**	**Deductible expenditure**	**Expenditure deductible in the 2023–24 income year**	**Excess deductions carried forward to future income year**
Property A	$16,500	$16,000		
Property B	$20,000	$22,000		
Total	**$36,500**	**$38,000**	**$36,500**	**$1,500**
Property-by-property basis				
Property C	$15,000	$13,000		
Excess amounts carried forward from prior income year		$8,000		
Total	**$15,000**	**$21,000**	**$15,000**	**$6,000**

The amount Rohan can claim in the 2023–24 income year in relation to his residential portfolio is the greater of the total deductible expenses and the residential income from the portfolio for the income year. In this case, that means Rohan can claim $36,500 of the expenses and has $1,500 of unused excess deductions relating to his residential portfolio to carry forward to the 2024–25 income year.

In relation to Property C, Rohan can claim $15,000 of the expenses and has $6,000 of unused excess deductions to carry forward to the 2024–25 income year. The effect of this is that Rohan has been able to offset $2,000 of the prior-year unused excess deductions against his residential income from Property C in the 2023–24 income year. Rohan has in total excess residential rental deductions of $7,500 available to carry forward to the 2024–25 income year.

Rohan’s tax summary for the 2023–24 income year is:

Taxable income	$0
Excess deductions to carry forward	$7,500

Part three – Calculating depreciation deductions

79. A person may claim a depreciation deduction for an item of depreciable property (for example, stove, carpets, fridge) that they use for income-earning purposes. Since the 2011–12 income year it is no longer possible to claim any depreciation on the residential property itself (including any fixtures or improvements).[3] A person cannot claim a depreciation deduction for chattels they use solely for private purposes.

80. The application of the rules can become complicated when a person has calculated depreciation deductions under the mixed-use asset rules in one income year and under the standard tax rules in the next income year, or the other way around.

81. If the standard tax rules apply, a person must consider whether the residential property ring-fencing rules limit a deduction for any depreciation loss. If the mixed-use asset rules apply, the amount of the depreciation deduction is limited by the apportionment calculation and may also be limited under the mixed-use asset quarantined expenditure rules.

82. The first step is to calculate the depreciation loss for the income year for each item of depreciable property. The next step is to work out what proportion of those losses a person may claim as a deduction in the income year.

83. If a person claims a depreciation deduction, they must keep a schedule of all the items of depreciable property they are depreciating. This schedule should show the depreciation the person has claimed in previous income years and the adjusted tax value (ATV) of each item of depreciable property.

Calculating depreciation loss

84. Before a person can apply any apportionment method, they must work out the depreciation loss for the income year for each item of depreciable property.

85. For low-value items (up to $1,000), the depreciation loss is the depreciable property's cost. For other items of depreciable property, a person must work out the depreciation loss for the income year using either the diminishing value (DV) method or the straight-line (SL) method. For information about the methods and the depreciation rates, see Inland Revenue's website: Depreciation rate finder and calculator.

86. The starting point to calculate the depreciation loss is to determine the ATV. An item's ATV is its "base value" less "total deductions".

[3] For the 2011–12 income year and subsequent income years, depreciation on residential buildings is 0% where buildings have an estimated life of more than 50 years.

87. Generally, the "base value" is the cost a person incurred in purchasing the item of depreciable property.

88. The "total deductions" amount includes all deductions for amounts of depreciation loss the person has been allowed or would have been allowed if the person had used the item wholly in deriving assessable income or carrying on a business for the purpose of deriving assessable income. That is, the "total deductions" amount is the amount before any apportionment under either the mixed-use asset rules or the standard tax rules.

89. Example | Tauira 6 illustrates how to calculate depreciation loss on a chattel used in a residential property.

Example | Tauira 6 – Calculating depreciation loss

Marama owns a two-bedroom property in Kaikōura.

Marama purchases a new leather lounge suite for $7,500 on 1 April 2020 for her Kaikōura property. The depreciation rate for loose furniture is 20% DV.

Marama calculates her depreciation loss for the 2020–21 income year as follows:

Opening ATV	Depreciation loss	Closing ATV
7,500	1,500	6,000

Example | Tauira 7 shows how Marama calculates her depreciation deduction for the 2020–21 income year.

Determining the depreciation deduction under the standard tax rules

90. Under the standard tax rules, a person can claim depreciation on items of depreciable property that they use or that are available for them to use in deriving taxable income.

91. If the item of depreciable property is wholly used to derive taxable income, the person can claim the full depreciation loss as a deduction. The next step is to determine whether the deduction is suspended under the residential property ring-fencing rules.

92. If the item of depreciable property is partly used to derive taxable income, the person must apportion between private and income earning use. The specific apportionment formula for depreciation of items partly used to earn income is (s EE 50):

depreciation loss × qualifying use days ÷ all days

93. “Qualifying use days” is the number of days the residential property is rented out or is available to be rented out. “All days” is the number of days in an income year the residential property is used or available for use for any purpose.

94. Where a person uses an item of depreciable property partly for private use and partly to earn income, s EE 50(2) states that the depreciation deduction “must not be more” than the amount calculated using the formula.

95. However, the depreciation deduction may be less than the amount calculated under the formula. This would be the case where the person uses the depreciable property for private purposes and to derive taxable income on the same day. In this situation, apportionment under the general permission for deductibility is appropriate (s DA 1). For example, if the item of depreciable property is used for both private and income earning purposes at the same time (for example, it is in a common use area) the Commissioner would generally accept the amount of the depreciation loss being apportioned 50:50 between the private use and the income-earning use (so 50% deductible and 50% non-deductible). However, where the actual use of the asset can be clearly demonstrated, an alternative basis may be adopted if it reflects a reasonable basis of apportionment.

Depreciation deductions may be suspended under the residential property ring-fencing rules

96. If a person uses the standard tax rules to calculate their depreciation deduction, they must also consider whether the residential property ring-fencing rules apply.

97. If the residential property ring-fencing rules apply to the residential property for the income year, the person may need to suspend a portion of the depreciation deduction (together with all other deductions for the property) and carry it forward to a future income year as an unused excess deduction.

98. Suspending a depreciation deduction in an income year does not change how the person calculates their depreciation loss in the next income year. A person calculates the ATV based on the total deductions they could have claimed before any suspension (see [88]).

99. A person must maintain records of any suspended depreciation deductions and track whether the amount is claimed as a deduction in a future income year. If the suspended depreciation deduction is claimed in a future income year this will impact how depreciation recovery income (see from [107]) or depreciation loss on sale (see from [118]) is calculated.

Determining the depreciation deduction under the mixed-use asset rules

100. If the residential property is a mixed-use asset, the mixed-use asset rules override the partial use rules in subpart EE.

101. Under the mixed-use asset rules, a person is allowed a deduction for an amount of depreciation loss to the extent of the amount calculated using the formula in s DG 9(2). The apportionment formula is set out in [39]. The effect of the formula is that the proportion of the depreciation loss that is deductible reflects the income-earning use of the mixed-use asset relative to the private use.

102. If the quarantined expenditure rules apply (see [42]) a person must quarantine a portion of the depreciation deduction and carry it forward to a future income year.

103. Any limitation of the depreciation deduction due to the mixed-use asset apportionment formula or the quarantined expenditure rules, does not change how a person calculates their depreciation loss in the next income year.

104. Example | Tauira 7 illustrates how depreciation deductions are calculated when the income tax deduction rules that apply to the residential property changes.

Example | Tauira 7 – Calculating depreciation deductions on chattels where the land regime that applies to a residential property changes

The same facts apply as in Example | Tauira 6.

During the 2020–21 income year, Marama stayed in her property from 20 December 2020 to 15 February 2021 (57 nights) and made the property available for short-stay accommodation for the remainder of the income year. In the 2020–21 income year, the property was booked for 170 nights and unused for the other 138 nights that it was available for short-stay accommodation. Marama's Kaikōura property is a mixed-use asset for the 2020–21 income year – see QB 25/02.

Because Marama's Kaikōura property is a mixed-use asset, Marama must determine the portion of the depreciation loss that is deductible under the mixed-use asset rules.

For the purposes of this example, Marama calculates her expenditure on the basis that the depreciation loss is her sole item of expenditure or loss.

Marama calculates her mixed-use asset expenditure using the following formula:

expenditure × income-earning days ÷ (income-earning days + counted days)

Expenditure = $1,500

Income-earning days = 170

Counted days = 57

Marama's mixed-use asset expenditure is $1,123.35.

Marama's deprecation deduction is $1,123.35. The amount of the depreciation deduction due to the mixed-use asset rules will not affect the calculation of the ATV of the leather lounge suite in the next income year. The ATV is $6,000 ($7,500 less $1,500) for the 2021–22 income year.

Towards the end of the 2020–21 income year, Marama is getting fewer short-stay bookings, so she decides to let the Kaikōura property to a tenant on a long-term basis. Marama's tenant occupies the Kaikōura property from 1 April 2021 to 31 March 2023.

As the Kaikōura property is not used privately during the 2021–22 income year or the 2022–23 income year, it will not be a mixed-use asset in those income years. The standard tax rules will apply to the Kaikōura property.

Marama calculates her depreciation loss in the 2021–22 and 2022–23 income years:

	Opening ATV	**Depreciation loss**	**Closing ATV**
2022	$6,000	$1,200	$4,800
2023	$4,800	$960	$3,840

Marama's rental activity makes a loss in both the 2021–22 and 2022–23 income years. Marama calculates that because of the application of the residential rental ring-fencing rules, she can claim deductions for 66.66% of her total expenditure for the property in the 2021–22 income year and 72.39% of her total expenditure for the property in the 2022–23 income year (that is, Marama's income from the residential property is 66.66% and 72.39% of the expenditure incurred in the 2021–22 and 2022–23 income years respectively).

On this basis, the depreciation deduction Marama can claim is limited to $800 in the 2021–22 income year and $695 in the 2022–23 income year.

The remainder of the depreciation deduction ($400 in the 2021–22 income year and $265 in the 2022–23 income year) is suspended and carried forward to future income years.

Part four - Sale of depreciable property

105. A person must calculate their depreciation recovery income or depreciation loss on sale if they:

- sell an item of depreciable property; or
- the item of depreciable property is not used to derive income (for example, they have sold the residential property the depreciable property was used in conjunction with).

106. The method to calculate depreciation recovery income or depreciation loss on sale is the same whether the mixed-use asset rules or standard tax deduction rules apply in the income year of disposal.[4]

Calculating depreciation recovery income

107. Depreciation recovery income arises when the depreciable property is sold for more than its ATV.

108. Generally, the depreciation recovery income is the lesser of:

- the amount by which the consideration is more than the item's ATV on the date of disposal; and
- the total of the amounts of depreciation loss for which a person has been allowed deductions for the item of depreciable property.

109. However, when a person partly used the item of depreciable property to produce income (for example, an item of depreciable property in a mixed-use asset), they must use a specific formula to calculate the depreciation recovery income (s EE 49).

Sale of depreciable property partly used to produce income

110. Section EE 49 applies if:

- at any time during the period a person owns an item of depreciable property, they determine the depreciation deduction under s EE 50 (see [92]); or
- the item of depreciable property is used in a mixed-use asset.

111. The formula in s EE 49 is:

$$\text{(all deductions} \div \text{(base value} - \text{adjusted tax value))}$$
$$\times \text{ amount of depreciation recovery income}$$

where:

[4] Section DG 8(2)(b) and (c) provide that for a mixed-use asset, depreciation recovery income is dealt with in s EE 49 and a depreciation loss on disposal is dealt with in ss EE 44 to EE 48 and s EE 50(6) and (7).

- "all deductions" means all amounts of depreciation loss for which the person has been allowed a depreciation deduction;
- "base value" generally means the cost of the item of depreciable property;
- "adjusted tax value" is the item's base value less "total deductions"; and
- "amount of depreciation recovery income" is the amount by which the sale proceeds is more than the item's ATV on the date on which the item is sold.

112. The depreciation recovery income formula takes into account deductions that have been allowed. If a person did not deduct all or part of a depreciation loss due to the mixed-use asset apportionment formula, the mixed-use asset quarantined expenditure rules, or the residential property ring-fencing rules, the denied amount would not be clawed back as depreciation recovery income.

113. After calculating depreciation recovery income, a person can determine the extent to which they can use unused excess deductions under the residential property ring-fencing rules, to offset the depreciation recovery income.

Offsetting unused excess deductions against depreciation recovery income

114. A person can offset unused excess deductions against depreciation recovery income if the residential property ring-fencing rules apportionment mechanism (s EL 4) applies to the residential property in the income year in which they sell the item of depreciable property. This is illustrated in Example | Tauira 8.

115. However, if the s EL 4 allocation mechanism does not apply to the residential property in the income year in which the person sells the item of depreciable property, they cannot use any previously unused excess deductions. While the depreciation recovery income will be residential income (s EL 3), if s EL 4 does not apply to the residential property due to an exclusion (for example, because it is a mixed-use asset for that income year (s EL 12)), the person cannot use any previously unused excess deductions against the depreciation recovery income. This is illustrated in Example | Tauira 9.

Unable to use prior-year mixed-use asset quarantined expenditure against depreciation recovery income

116. Mixed-use asset quarantined expenditure carried forward from a prior income year may be offset against "asset income" in the current income year (s DG 17). "Asset income" is the total amount of taxable income derived in the current income year from "the use of the asset" (s DG 17(3)(a)).

117. While depreciation recovery income generally consists of the reversal of depreciation deductions, it arises on the sale of the depreciable property rather than from the use of the asset. Because depreciation recovery income is not "asset income", a person cannot offset prior-year mixed-use asset quarantined expenditure against depreciation recovery income.

Example | Tauira 8 – How to calculate depreciation recovery income from the sale of an item of depreciable property in a residential rental property

The same facts apply as in Example | Tauira 6 and Example | Tauira 7. Marama's depreciation treatment of the leather lounge suite is as follows:

Income year	Opening ATV	Depreciation loss	Closing ATV	Deductions
2020–21	$7,500	$1,500	$6,000	$1,123.35
2021–22	$6,000	$1,200	$4,800	$800
2022–23	$4,800	$960	$3,840	$695

Marama continues to rent out her Kaikōura property to a long-term tenant in the 2023–24 income year. On this basis, Marama uses the standard tax rules to calculate her income and expenditure from the Kaikōura property.

On 1 April 2023 Marama sells the lounge suite for $5,000.

Because the sale proceeds are more than the lounge suite's closing ATV, Marama must determine her depreciation recovery income using the following formula:

$$\text{(all deductions} \div \text{(base value} - \text{adjusted tax value))}$$

$$\times \text{ amount of depreciation recovery income}$$

All deductions = $2,618.35 ($1,123.35 + 800 + 695)

Base value = $7,500

Adjusted tax value = $3,840

Amount of depreciation recovery income = $1,160 ($5,000 less $3,840)

Total depreciation recovery income = $829.86

Marama must return the depreciation recovery income in her 2023–24 income tax return.

The standard tax rules and residential property ring-fencing rules apply to the Kaikōura property in the 2023–24 income year. On this basis, Marama will be able to offset her unused excess deduction carried forward from earlier income years.

Marama calculates her net income as follows:[5]

Depreciation recovery income	$829.86
Excess amounts carried forward from prior year – 2021–22	($400)
Excess amounts carried forward from prior year – 2022–23	($265)
Net income	**$164.86**

Example | Tauira 9 – How to calculate depreciation recovery income from the sale of an item of depreciable property used in a mixed-use asset

Hudson owns a three-bedroom property in Hamilton. He purchased it as a rental investment and let it to tenants from 1 April 2021 to 31 March 2023.

The standard tax rules applied to the Hamilton property in the 2021–22 and 2022–23 income years. The residential property ring-fencing rules apply to limit Hudson's deductions in the 2021–22 and 2022–23 income years.

Hudson let the three-bedroom property partially furnished and then purchased a new dining suite for $2,500 on 1 April 2021. The depreciation rate for loose furniture is 13.5% SL.

During the 2023–24 income year, Hudson's tenants move out. Hudson is unable to secure new tenants, and the property is unoccupied for 3 months until he decides to move into the property himself.

The Hamilton property is a mixed-use asset for the 2023–24 income year.

Hudson's depreciation treatment of the dining suite is as follows:

Income year	Opening ATV	Depreciation loss	Closing ATV	Deduction
2021–22	$2,500.00	$337.50	$2,162.50	$280.00
2022–23	$2,162.50	$337.50	$1,825.00	$275.00
2023–24	$1,825.00	$337.50	$1,487.50	$130.00

In the 2023–24 income year, $207.50 of the depreciation loss was disallowed as a deduction under the mixed-use asset rules. The amount of disallowed depreciation loss includes $83 of quarantined expenditure (that is, expenditure that is not

[5] For the purpose of this example, we have ignored any rental income or other deductions for the income year.

deductible in the income year but instead carried forward to a future income year for use against income derived from the Hamilton property in the future).

On 1 April 2024, Hudson decides to sell the dining suite for $2,000.

Because the sale proceeds Hudson receives are more than the dining suite's closing ATV, he must return depreciation recovery income using the following formula:

$$\text{(all deductions} \div \text{(base value} - \text{adjusted tax value))}$$
$$\times \text{ amount of depreciation recovery income}$$

All deductions = $685 ($280 + $275 + $130)

Base value = $2,500

Adjusted tax value = $1,487.50

Amount of depreciation recovery income = $1,012.50 ($2,500 less $1,487.50)

Total depreciation recovery income = $685

Hudson must return the depreciation recovery income of $685 in his 2023–24 income tax return.

The standard tax rules do not apply to the Hamilton property in the 2023–24 income year. For this reason, Hudson cannot offset his unused excess deductions carried forward from the 2021–22 income year ($57.50) and 2022–23 income year ($62.50). Further, Hudson cannot offset the prior-year quarantined expenditure amount ($83) against the depreciation recovery income.

Calculating depreciation loss on sale

118. If a person sells an item of depreciable property for less than the item's ATV, they will incur a depreciation loss on sale (s EE 48(2)).

119. Generally, the amount of the depreciation loss on sale is the amount by which the consideration is less than the item's ATV on that date. However, when a person partly uses the item of depreciable property to produce income (for example, an item of depreciable property in a mixed-use asset), they must use a specific formula to calculate the depreciation recovery income (s EE 50(6)).

Sale of depreciable property partly used to produce income

120. The formula in s EE 50(6) applies if a person sells an item of depreciable property at a loss and, during the period they owned that item, they used it partly to produce income and calculated the amount of depreciation deduction under s EE 50(2).

121. The formula in s EE 50(6) is:

disposal depreciation loss × all deductions

÷ (base value − adjusted tax value at date of disposal)

where:

- "disposal depreciation loss" means the sale consideration less the ATV;
- "all deductions" means all amounts of depreciation loss for which the person has been allowed a depreciation deduction;
- "base value" generally means the cost of the item of depreciable property; and
- "adjusted tax value at date of disposal" is an item's base value less "total deductions" at the date of sale.

122. The effect of the formula is that the loss on sale is apportioned in the same proportion as the depreciation deductions were apportioned.

123. Example | Tauira 10 illustrates how to calculate depreciation loss on the sale of an item of depreciable property.

Example | Tauira 10 – Calculating depreciation loss from the sale of an item of depreciable property used in a mixed-use asset

Keely owns a two-bedroom holiday home in Arrowtown. It is a mixed-use asset, and she calculates her income and expenditure from the holiday home under the mixed-use asset rules.

Keely purchases a $1,800 fridge for her holiday home on 1 April 2021. The depreciation rate for fridges is 17.5% SL.

Keely's depreciation loss is as follows:

Income year	Opening ATV	Depreciation loss	Closing ATV	Deductions
2021–22	$1,800	$315	$1,485	$236
2022–23	$1,484	$315	$1,170	$283
2023–24	$1,170	$315	$855	$267

The mixed-use asset apportionment formula has limited Keely's depreciation deductions in the 2021–22 to 2023–24 income years.

Keely sells the fridge for $500 on 1 April 2024. As the amount Keely receives is less than the fridge's ATV, she has incurred a depreciation loss on sale.

Keely calculates her depreciation loss on sale using the following formula:

disposal depreciation loss × all deductions

÷ (base value − adjusted tax value at date)

Disposal depreciation loss = $355 ($855 less $500)

All deductions = $786 ($236 + $283 + $267)

Base value = $1,800

Adjusted tax value at date = $855

Total depreciation loss on disposal = $295.27

Keely will be able to claim a deduction in the 2024–25 income year for the depreciation loss on disposal of $295.27.

References | Tohutoro

Legislative references | Tohutoro whakatureture

Income Tax Act 2007 – ss CC 1, DA 1, DG 3, DG 8, DG 9, DG 16, DG 17, DG 21, EE 38, EE 44 to EE 48, EE 49, EE 50, EL 3, EL 4, EL 6, EL 9, EL 12, and the definition of "main home" in s YA 1

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About this document | Mō tēnei tuhinga

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