

# Mixed-use assets

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*An officials' issues paper*

**August 2011**

*Prepared by the Policy Advice Division of the Inland Revenue Department and by the New Zealand Treasury*

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# CHAPTER 1

## Introduction

- 1.1 In Budget 2011 the Government announced its intention to review the tax treatment of assets used for both private and income-earning purposes (mixed-use assets) as part of its ongoing commitment to ensuring fairness across the tax system.
- 1.2 This issues paper suggests two alternative methods of prescribing deductions for expenditure in relation to these kinds of assets, and seeks readers' views on how these methods might work in practice.

### The issue

- 1.3 A good example of a mixed-use asset is a holiday home which is used by both the owner and the owner's family for private use, and also rented out. Other assets such as yachts and aircraft can also be used in this way.
- 1.4 Under the current income tax rules, if the inward cash flows derived from a mixed-use asset are assessable income, the owner can claim deductions for expenditure that was incurred in deriving that income. However, the owner cannot claim a deduction when the expenditure is private in nature. These statutory rules are general and can be difficult to apply to mixed-use assets, in particular when it is not clear whether the expenditure relates to either income-earning use or private use of the asset.
- 1.5 Expenditure relating to these kinds of assets falls into three categories:
  - Expenditure which relates only to the income-earning use of the asset, such as advertising expenditure. This expenditure is clearly deductible.
  - Expenditure which relates only to the private use of the asset, such as repairs to damage caused by private users. This expenditure is clearly not deductible.
  - Expenditure which relates to the time when the asset is not used. An example would be storage fees for a yacht when it is out of the water. It is not clear whether this expenditure is attributable to either the income-earning use or the private use of the asset.

Some expenditure, such as interest, is incurred throughout the year and will fall into all three categories.

- 1.6 This paper is concerned with the uncertainty that arises around the deductibility of the last category of expenditure described above.

- 1.7 In 2009 Inland Revenue issued Guidelines on deductibility of expenditure relating to holiday homes. These guidelines are Inland Revenue's interpretation of the law, but like all guidelines, they have limitations. Guidelines can only offer general advice to owners, and do not have the certainty that specific statutory provisions provide.
- 1.8 It is not clear whether the correct result is achieved in all circumstances under current law and guidelines. In some instances, owners are claiming deductions which appear to be disproportionate to the income-earning use of assets. An important aspect of our tax system is that it is fair. In this context, owners should only be able to claim deductions when those deductions truly relate to the earning of assessable income.
- 1.9 This paper outlines two alternative approaches for a set of statutory rules that prescribe and moderate tax deductions for mixed-use assets.

### **Suggestions**

- 1.10 The suggested new rules categorise mixed-use assets into different groups based on the underlying use of the asset, and prescribe the level of deductions that owners in each group can claim. Two possible alternative approaches are suggested:
- The first uses a single test to identify whether an owner of an asset has an income-earning focus. If the test is passed, the owner would be able to claim all deductions except for expenditure that is directly attributable to actual private use. If the test is failed, the owner will only be able to claim expenditure attributable to actual income-earning use.
  - The second approach includes the income-focused outcome described above, and also an outcome where the owner is only able to claim expenditure attributable to actual income-earning use. However, it also recognises a third, "middle" category of mixed-use asset, where the asset is used to earn significant income, but also to provide a reasonable level of private use. Expenditure relating to assets in this category is apportioned between deductible and non-deductible.
- 1.11 The key difference with the second approach is that deductions for expenditure that cannot be easily identified as relating either to private or income-earning use (because it relates to days when the asset is not used) are apportioned based on the level of income-earning and private use.

## **Summary of suggested changes**

- The suggested changes moderate deductions which can be claimed in relation to mixed-use assets, primarily those deductions which relate to the time the asset is not being used. Assets will be divided into either two or three categories, depending on how they are used, which will determine the entitlement to claim deductions.  
(See Chapter 3.)
- Various tests will set out whether asset owners will be entitled to deductions for all expenditure which relates to periods the asset is not being used, part of that expenditure, or none of it. The tests will consider matters such as:
  - whether the asset was used for income-earning purposes for 62 days in the income year;
  - whether the proportion of private use in relation to the income-earning use was less than a given threshold; and
  - whether the asset was actively marketed.(See Chapters 3 and 4.)
- The suggested changes will apply only to:
  - assets which are used for both income-earning purposes and privately rented out on a short-term basis and which are unused for at least two months in every 12;
  - land and other assets with a cost of \$50,000 or more;(See Chapter 5.)
  - assets ultimately controlled by a small number of individuals – that is, assets owned by individuals, partnerships, some trusts, close companies, qualifying companies and look-through companies.(See Chapter 6.)
- For GST purposes, similar proposals will apply to assets held by GST-registered persons.  
(See Chapter 7.)

## **Key points for submissions**

- 1.12 Specific issues for comment are set out at the end of each chapter.
- 1.13 Submissions are also invited more generally on the changes proposed in this paper, such as:
- Would a simple approach, which has an unavoidable degree of arbitrariness be better than a more complex approach where asset owners' circumstances and their tax treatment are more closely matched?

- Would the criteria outlined for the various tests detailed in this paper be the best way to identify categories of asset owners?
- Is the proposed tax treatment of asset owners in each category appropriate?
- Would the suggested changes create unwarranted compliance costs and to what degree?

### **Next steps**

- 1.14 Once the consultation period has closed, officials will report to Government, with any legislative changes likely to be introduced to parliament in 2012.

### **How to make a submission**

- 1.15 Submissions should be addressed to:

Mixed-use assets  
 C/- Deputy Commissioner Policy  
 Policy Advice Division  
 Inland Revenue Department  
 P O Box 2198  
 Wellington 6140

- 1.16 Alternatively, submissions can be made by e-mailing:  
 “policy.webmaster@ird.govt.nz” with “Mixed-use assets” in the subject line.
- 1.17 The closing date for submissions is 30 September 2011.
- 1.18 Submissions should include a brief summary of major points and recommendations. They should also indicate whether the authors are happy to be contacted by officials to discuss the points raised, if required.
- 1.19 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their publication. The withholding of particular submissions on the grounds of privacy, or for any other reason will be determined in accordance with that Act. You should make it clear if you consider any part your submission should be withheld under the Official Information Act.



## CHAPTER 2

### Legal background and the case for change

- 2.1 The ability of owners of mixed-use assets to claim deductions for expenditure is a consequence of the current statutory framework, case-law, and Inland Revenue's approach to that statutory framework. The various elements are discussed below. Due to the uncertainty in this area a "case for change" is presented.

#### Statutory provisions

- 2.2 Apart from subpart DE of the Income Tax Act 2007, which sets out the rules for motor vehicles there are no specific statutory rules governing deductibility of expenditure relating to mixed-use assets.<sup>1</sup> For all other mixed-use assets, the approach used to determine deductions can only be extrapolated from general statutory rules and case-law.
- 2.3 The following two statutory rules set out the fundamental requirements for expenditure to be deductible:<sup>2</sup>
- section DA 1: A person is allowed a deduction for an amount of expenditure or loss (including an amount of depreciation) to the extent to which the expenditure or loss is incurred in deriving their income (both assessable and excluded income) or incurred in the course of carrying on a business for deriving such income; and
  - section DA 2(2): A person is denied a deduction to the extent to which the expenditure is of a private or domestic nature.
- 2.4 Broadly, a person is allowed a deduction for expenditure incurred in deriving assessable income or in the course of carrying on a business. However, that person is unable to claim a deduction for expenditure that is private in nature. In addition, the rules contain the phrase "to the extent". This phrase contemplates that an item of expenditure may be apportioned between the amount that is attributable to income-earning use and the amount attributable to private use.
- 2.5 These statutory provisions can be difficult to apply to mixed-use assets, since a mixed-use asset has both income-earning and private use elements. Determining what expenditure is attributable to income-earning use, or carrying on a business (deductible expenditure) as opposed to the private use of the asset (non-deductible expenditure) can be difficult when expenditure relates to periods when the asset is not being used.

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<sup>1</sup> These rules are briefly discussed in Chapter 5, "Assets subject to the new proposals".

<sup>2</sup> Income Tax Act 2007.

**Example**

A holiday home is used by the owners for five weeks per year and is also rented out for five weeks per year. The owner has incurred expenditure that directly relates to the actual private use of the home, the actual rental use of the home, and expenditure that relates to the 42 weeks of the year when the home was not in use.

There is no concern about the owner claiming deductions for expenditure which relates to the five weeks per year the home is rented. It is equally clear that no deductions can be claimed for the five weeks per year when the home is used by the owner. The issue is to what extent the owner should be able to claim deductions which relate to the 42 weeks per year the house is empty.

**Case-law**

- 2.6 The leading case on mixed-use assets is *CIR v Banks* (1978) 3 NZTC 61,236. In this case the taxpayer used a room in his house for income-earning purposes for a certain number of hours per week for a certain number of weeks of the year. The Court of Appeal was asked to consider whether a deduction could be claimed for any proportion of a private home used for income-earning purposes, and held that a deduction could be claimed. However, the Court of Appeal noted that determining an appropriate apportionment calculation was difficult. The Court accepted an apportionment method which provided a deduction for some expenditure relating to periods of non-use.
- 2.7 In *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271, the taxpayer paid amounts to an employee to obtain the employee's resignation and for a restrictive covenant. The question for the Court of Appeal was whether the expenditure should properly be treated as deductible or on capital account. The Court made some interesting comments about deductions in relation to mixed-use assets:

*The circumstances of the particular case will usually determine what is the most apt way of deciding how much of the expenditure is attributable to the deductible item. For example, where an asset, such as a house or car, is used for both business and private purposes, the apportionment of total expenses must be fairly based on the use (and some cases availability for use) for business purposes and private purposes respectively. Even so, it is impossible to prescribe any precise formula applicable to all cases. Each such case depends on its own circumstances. It is the yardstick of factual use, or availability for use for business purposes, that satisfies the requirement that the apportionment must be fair not arbitrary, and must be done as a matter of fact.*

- 2.8 "Factual use" criteria underlie both Inland Revenue's interpretation and suggestions for a new approach in this area, discussed in subsequent chapters.

- 2.9 The court later made the following more general comment about apportionment:

*The more difficult class of case is where each advantage is intangible and does not lend itself to measurement against any conventional yardstick. It then becomes a matter of deciding whether there is any, and if so sufficient, evidence to justify a conclusion that some particular part of the total expenditure is actually attributable to a deductible item, or at least a minimum fractional share of the total expenditure can be realised as so attributable. If there is insufficient evidence to arrive at a conclusion, any answer must be mere speculation and the taxpayer will have failed to discharge the onus of proof upon him.*

- 2.10 This statement is clear authority for a restrictive approach to be taken to allowing deductions relating to expenditure incurred during periods when mixed-use assets are not actually being used.

### **Inland Revenue's guidance**

- 2.11 As noted above, the owners of mixed-use assets other than motor vehicles must apply general law to determine the deductibility of their expenditure. One way to bridge the gap between general provisions and situations which give rise to interpretative difficulty is by way of guidance published by Inland Revenue. While this guidance is not binding on taxpayers or Inland Revenue, it can provide a greater level of certainty than would otherwise exist. Taxpayers typically apply these statements to their situation with a reasonable level of confidence if their circumstances are close to the circumstances described in the guidance.
- 2.12 In 2009, Inland Revenue released a *Questions we've been asked* (QWBA) entitled "Holiday houses – income tax treatment". It gives guidance to owners of holiday homes on deductions they could claim, and specifically whether they could claim deductions for non-use periods (*Tax Information Bulletin*, Vol 21, No 3, May 2009).  
(See also [www.ird.govt.nz/technical-tax/questions/questions-general/qwba-0902-holiday-houses.html](http://www.ird.govt.nz/technical-tax/questions/questions-general/qwba-0902-holiday-houses.html).)
- 2.13 The QWBA indicated that if the holiday house was advertised as genuinely available for use in the empty periods the owner could, in certain circumstances, claim deductions for expenses incurred in these periods. However, when a holiday home was essentially available only to the owner, and the owner's family and friends, and available to rent to third parties on a limited basis, no deduction could be claimed for the period the home was not rented.

- 2.14 The QWBA indicated that additional evidence would be required before an owner could claim expenditure for non-use periods:

*Evidence of a holiday house being available for rent generally needs to be more than a mere statement of its availability, sporadic or limited advertising, or advertising that is of a nature that is unlikely to attract many customers. There must be evidence of active and regular marketing of the holiday house at market rates and of the availability of the holiday house at times and for periods that demonstrate the holiday house is earning rental income or is genuinely available to earn rental income.*

*If a holiday house is available for only limited and/or undesirable periods and/or at non-competitive rates, such factors tend to indicate that the expenditure is not incurred in deriving assessable income.*

- 2.15 Examples were provided to demonstrate the application of the current rules:

- A holiday home earns significant rental income and is actively marketed, but used by the owners for two weeks over Christmas and New Year. The owners can claim deductions for the entire year with the exception of the two weeks the property is used.
- A holiday home is used privately for most of the year and rented for two weeks per year. The owners can claim deductions only for the period the holiday home is actually rented out.

### **The case for change**

- 2.16 As discussed, the statutory tests apply to allow a deduction for expenditure incurred in deriving income or in carrying on a business, and deny a deduction for expenditure which is private in nature. However, the application of these statutory rules to expenditure that relates to the time the asset is unused is uncertain. The fundamental difficulty with this type of expenditure is that it could be argued that both sections DA 1 and DA 2(2) of the Income Tax Act 2007 apply to it.

- 2.17 *CIR v Banks* and other cases arguably provide support that a deduction for such expenditure is allowable on an apportionment basis, but do not provide detailed rules on how any apportionment is to be applied.

- 2.18 While Inland Revenue's QWBA guidance is a logical approach to resolving the application of legislative uncertainty in this area, there are some limitations:

- The guidance applies only to holiday homes, and does not cover other assets which might be both used privately and rented out, such as yachts.
- The examples given are necessarily limited and cannot cover all situations.

- As with all guidance, only general advice can be provided and taxpayers are free to argue that it does not apply to them.

### **Increasing deductions claimed**

2.19 While it has always been possible to rent out these kinds of assets, the practice has increased in recent years for a number of reasons – including:

- Dedicated internet sites for holiday homes make it easier to rent out holiday homes by providing renters with detailed information about properties on offer.
- A number of yacht charter businesses which market through the internet have been established where private yacht owners can list their yacht. The yacht charter business advertises the boats and arranges for them to be chartered, returning some of the charter fee to the yacht owner.

### **The need for fairness and certainty**

2.20 The discussion set out in this chapter illustrates some of the difficulties arising from the current tax deductibility rules for mixed-use assets.

2.21 This situation gives rise to less-than-ideal outcomes in terms of fairness, certainty and economic efficiency, all of which are important elements of a good tax system.

2.22 The remaining chapters of this paper explore options for a new legislative approach to determining the eligibility of owners of mixed-use assets for deductions, with the objective of making the rules fairer, more certain and more economically efficient.

## CHAPTER 3

### Framework for the allocation of expenditure between uses

- 3.1 The suggested new rules categorise mixed-use assets into different groups based on the underlying use of the asset, and prescribe the level of deductions that owners in each group can claim. This chapter considers two alternative frameworks for the proposed changes, namely, the three-outcome approach and the two-outcome approach.
- 3.2 The two approaches are explained and evaluated below. The details of the tests which make up each approach are discussed in the next chapter.

#### Three-outcome approach

- 3.3 The three-outcome approach uses two tests to distinguish between three groups of mixed-use asset. The rules prescribe different levels of deductions that owners in each group are able to claim.
- 3.4 The following outlines each group and the level of deductions each group is able to claim:
- **The private-focused group:** The combination of effort and success at earning income is low. In this case, the owner is only able to claim expenditure which relates to the actual income-earning use of the asset, and no deduction can be claimed for expenditure that relates to the time the asset is not used.
  - **The genuine mixed-use group:** The effort and success in earning income is reasonably high, but there is a greater level of private use than the income-focused group. In this case, the owner is able to claim expenditure which relates to the actual income-earning use of the asset, and a proportion of expenditure that relates to the time the asset is not used can be claimed.
  - **The income-focused group:** The effort and success in earning income is reasonably high, and private use is limited. In this case, the owner is able to claim expenditure which relates to the actual income-earning use of the asset, and all the expenditure that relates to the time the asset is not used can be claimed..
- 3.5 The genuine mixed-use group is able claim a proportion of expenditure that relates to the time the asset is not used under a general apportionment rule. The apportionment rule would use the following formula:

$$\text{Deductions} = \frac{\text{Unused time expenditure}}{\text{Actual income-earning use} + \text{Actual private use}} \times \text{Actual income-earning use}$$

**Example**

Jill uses her holiday home herself for five weeks a year and rents it for five weeks a year. Expenditure relating to the 42 weeks of the year that the holiday home is unused (unused time expenditure) is deductible at a rate of 50% calculated as five weeks income-earning use divided by 10 weeks of total use.

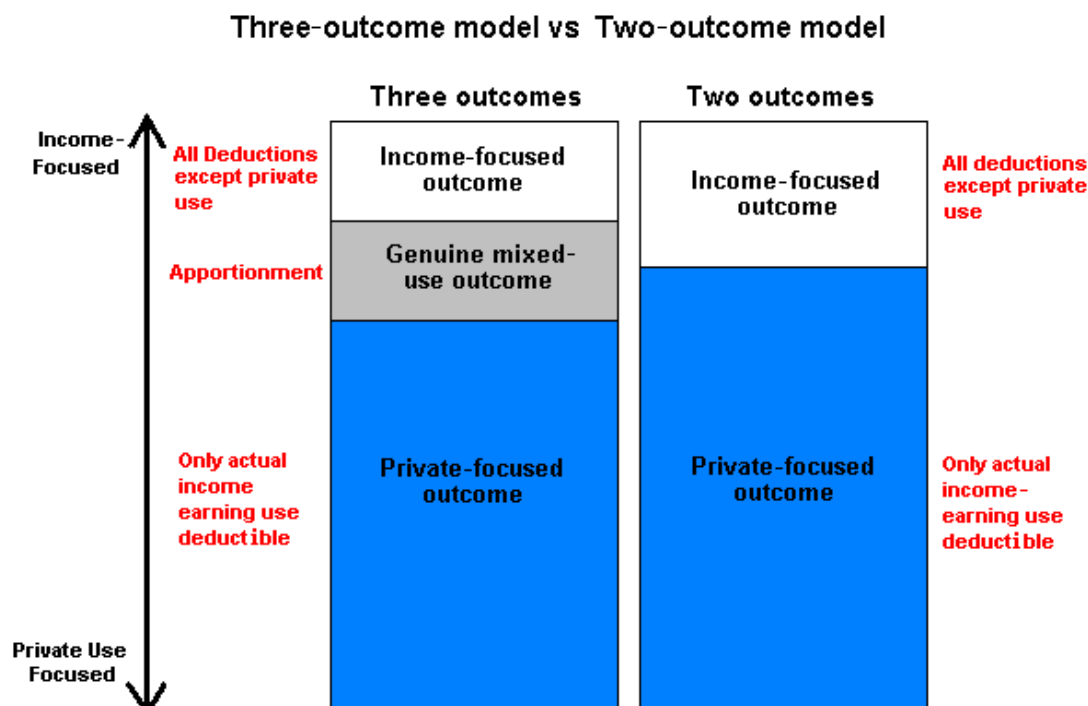
**Two-outcome approach**

- 3.6 The three-outcome approach can be simplified by removing the genuine mixed-use group under which the apportionment calculation is carried out. This creates the two-outcome approach. This would leave only the private-focused group, under which unused time is not deductible at all, and the income-focused group, under which all expenditure associated with unused time is deductible.
- 3.7 All mixed-use assets would be categorised as follows:
- For those who actively market their asset and have a reasonably low level of private use, deductions would be available for all unused time expenditure.
  - For all others, no deductions would be available for unused time expenditure as the asset has a private-focused outcome.

**Comparison between the two approaches**

- 3.8 An important difference between the three-outcome model and the two-outcome model is that the test to qualify for the income-focused group would be easier to pass under the two-outcome model. This difference is necessary because the consequence of not falling into the income-focused group in the two-outcome model is denial of all deductions which relate to the time the asset is unused. This can be compared with the three-outcome model which provides apportionment as an outcome for those who combine significant income-earning activity with some private use.

3.9 This difference is explained in the following diagram:



3.10 The number of people for whom the income-focused outcome would apply is deliberately larger under the two-outcome approach than under the three-outcome approach. This means those who have a significant income-earning focus but some private use of their asset are likely to prefer the two-outcome approach.

3.11 The reverse is true for those who have an income-earning focus but a larger amount of private use. They are likely to be able to claim a deduction for a proportion of their unused time under the three-outcome approach (where the genuine mixed-use outcome will apply), but no deduction under the two-outcome approach (where the private-focused outcome will apply).

3.12 What these two differences show is that neither the two-outcome nor the three-outcome approach is, overall, more generous than the other. Those who have either a strong income-earning focus or a strong private use focus will receive the same treatment under either proposal, and those in the middle may prefer one or the other depending on exactly where they fall.

3.13 The three-outcome approach presents a reasonably sophisticated solution that aims to match asset owners' individual circumstances with some degree of precision. Compared with the two-outcome approach, there are fewer grounds for arguing that its treatment of asset owners is unfair. However, these advantages must be weighed against the disadvantage of the additional complexity. The three-outcome approach has two tests, rather than the single test of the two-outcome approach. It also includes the apportionment formula, which delivers apportionment percentages specific to each asset owner's circumstances, but which in itself is a reasonably complex tool.



- 3.14 By contrast, the two-outcome approach is relatively simple. Only one test need be applied, and the result is that asset owners fall into one of two categories. However, this simplicity results in some degree of arbitrariness. An asset owner at the margin can easily switch from being entitled to deductions for all unused time expenditure, to being entitled to no deductions for any of it, which is a dramatic difference.

**Submission point**

Each of the approaches set out above has advantages and disadvantages, and at this stage officials have no strong preference for one over the other. Accordingly, submissions are invited on whether, at a framework level, the two-outcome or three-outcome approach is preferred. Leaving aside the detail of the tests, do you prefer the three-outcome or the two-outcome framework? Why?

## CHAPTER 4

### Tests

- 4.1 Two possible alternative approaches have been suggested – the two-outcome approach, or the three-outcome approach. The outcome of the test(s) will determine the amount of deduction owners can claim. A range of outcomes are possible under either approach, ranging from all expenditure being deductible (other than purely private expenditure) to only expenditure that relates to actual income-earning use being deductible.
- 4.2 This chapter evaluates the possible contents of the test(s) that determine the amount of deductions asset owners may be able to claim. The test(s) could comprise a number of different elements, from an evaluation of the owner's subjective intentions, to objective requirements based on the actual use of the asset and the behaviour of the owner.

#### Possible test elements

- 4.3 The test(s) should correctly distinguish between and identify each category of mixed-use asset, and prescribe the correct outcome with a considerable degree of certainty, and without being overly burdensome for owners to comply with.
- 4.4 The test(s) could contain subjective and/or objective elements. Subjective elements attempt to ascertain the intention of the owner in relation to the asset, and objective elements look at the factual circumstances surrounding the use of the asset. An evaluation of the relative advantages and disadvantages of each element is necessary before a test can be constructed.
- 4.5 A wide variety of elements are possible, and any combination of these elements can make up the final test or tests. Some suggested elements include:
- whether the owner had the dominant purpose of earning income from the asset;
  - the common-law business test;
  - whether the asset was actively and regularly marketed as available for use at market rates;
  - whether actual income-earning use or actual private use falls below or above a given threshold;
  - whether private use was merely incidental or necessary to the income-earning use;
  - whether private use of the asset conflicted with the income-earning use of the asset; and
  - whether the incoming receipts exceeded the expenditure.

4.6 The following is an analysis of the possible elements of the proposed tests.

***Whether the owner had the dominant purpose of earning assessable income from the asset***

4.7 This is a subjective element that would require the owner to declare his or her intention in holding the asset. If the owner has this purpose, the owner could be given a higher amount of deductions.

4.8 The advantages of this element are:

- It may reveal the owner's intentions in holding the asset. This is an efficient way of getting to an equitable outcome.
- It may deal appropriately with difficult situations when the asset cannot be rented out because of circumstances such as an adverse natural event. Objective tests based on actual use often fail to accommodate such circumstances.
- It is likely to be relatively easy for an owner to comply with, as the owner should know his or her own intention.

4.9 However, a purely subjective test relies heavily on the owner's honesty, and that the owner will not falsify his or her intention in order to qualify for an outcome that allows higher deductions. This makes such rules difficult to administer and creates uncertainty for owners as they can be unsure about whether Inland Revenue will accept their stated intention.

4.10 Another issue that arises with this element is the period it would be measured over. Owners can develop intentions regarding the use of the asset on acquisition, each year, or intentions can change during the course of a year.

***The common-law business test***

4.11 The common-law business test contains both a subjective test and a number of useful objective tests that determine whether an income-earning activity equates to "a business". If an owner passes the business test he or she is likely to be income-focussed and should qualify for a higher amount of deductions. The common-law business test contains the following elements:

- what the nature of the activity was;
- whether the asset was actively marketed;
- the amount of time, money and effort the person put into the activity;
- the income earned from the activity;
- whether the person runs the activity in a similar way to most businesses in the same trade; and
- whether the dominant purpose of carrying out the activities is to make a profit.

- 4.12 The advantage of the common-law business test is that the test is already developed and available for application to the mixed-use asset rules. Furthermore, use of this test for mixed-use assets would align the treatment of mixed-use assets with other tax areas, so bringing the benefits of consistency. The common-law business test also evolves over time ensuring the test is always relevant.
- 4.13 However, there are some disadvantages associated with the business test. Firstly, it may be difficult to apply to some mixed-use assets. For instance, the rental activities of a single holiday home may never amount to “a business”. The business test is also a reasonably sophisticated and complex test to apply, requiring a number of different elements to be considered and weighed up. Consequently, the potential application of the business test could be a considerable compliance burden for owners, and is open to challenge by Inland Revenue. This is likely to create uncertainty over the level of deductions owners are able to claim.

***Genuine efforts to earn income evidenced by active and regular marketing of the asset at market prices***

- 4.14 This element would require the owner of a mixed-use asset to actively and regularly advertise the asset at a market rent, including all periods of non-use for which the asset can reasonably be used. This element attempts to determine whether the asset was genuinely available for income-earning use, and if passed the owner should be entitled to a higher level of deductions..
- 4.15 In general, periods during which the asset was not in use, and not actively and regularly marketed, would be a strong indication that the asset was not genuinely available for income-earning use. Furthermore, if the asset were advertised at an unreasonably high price in those non-use periods, thereby making it unlikely that anyone would rent the asset, the asset is also arguably not genuinely available for income-earning use during those periods.
- 4.16 An advantage of this approach is that it is a reasonably accurate way of identifying whether the asset really was available for income-earning use during periods of non-use. A further advantage is that satisfaction of this element is relatively easy to demonstrate.
- 4.17 However, this element also gives rise to a number of complexities including:
- What constitutes “active and regular marketing”? For example, would advertising a holiday home on a website be enough to satisfy the test?
  - What constitutes a market rent?
  - Advertising on its own may not necessarily be a good indication that the asset was genuinely available for use over non-use periods. For example, the owner may choose not to respond to rental enquiries for periods that the owner would like to use the asset privately.

- During what periods should the owner be required to advertise the asset? At certain times it may not be practical to use an asset for income-earning purposes, for instance when repairs and maintenance are carried out, or during times of very low demand. At a minimum the asset should be advertised in periods that demonstrate a genuine income-earning purpose. For example, a ski chalet should be advertised as available for use in the ski season.

***Actual income-earning use or actual private use is below or above a given threshold***

- 4.18 This objective element is known as a “bright-line” test. A bright-line test is a clearly defined rule or standard. In this context the owner of a mixed-use asset is prescribed an outcome depending upon whether the actual use of the asset is above or below a given threshold. Similar bright-line tests are used in the United Kingdom and the United States. Examples include:
- when actual income-earning use exceeds a certain number of days;
  - when actual private use is less than a certain number of days; or
  - when actual private use is less than a given percentage of actual income-earning use.
- 4.19 If one or more tests are satisfied, the owner could qualify for a higher amount of deductions. The primary advantages of bright-line tests are that they are reasonably simple to understand and comply with, and give owners some certainty over the level of deductions they are likely to be able to claim.
- 4.20 On the other hand, a bright-line test has dramatic marginal effects. An owner could face starkly different outcomes depending on whether their asset use was above or below the threshold. For example, if the bright-line test was set at 62 days of income-earning use, an owner who had 63 days of actual income-earning use would pass the test and qualify for a higher level of deductions. An owner who only achieved 61 days of actual income-earning use would fail the test and would receive significantly lower levels of deductions. This may be perceived as unfair, as only two days of income-earning use separate the two owners, yet they would receive completely different tax outcomes.
- 4.21 A bright-line test based on actual income-earning use also assumes that all mixed-use assets would achieve the income-earning threshold if the owner put in a reasonable amount of effort to rent out the asset. This could be an unreasonable assumption. For example, if the bright-line test were set at 93 days of income-earning use, the owner of a ski chalet used predominantly in the winter ski season may genuinely want to earn income from the ski chalet, but is unable to achieve 93 days rental due to a poor ski season that year. This may be perceived as an unfair outcome.
- 4.22 In practice, different mixed-use assets have different income-earning potential, and therefore a single bright-line test may not be suitable for every asset. However, the application of different bright-line tests for different assets would be complex and would result in difficult boundary issues.

- 4.23 Lastly, a bright-line test based on private use could be difficult to enforce. Receipts derived from income-earning use could easily be used to provide proof of that income-earning use. However, evidence proving the existence of private use is more difficult to obtain. Consequently, there would be some risk that owners would understate their private use of the asset in order to qualify for a more generous tax outcome.

***Private use was merely incidental or necessary to the income-earning use***

- 4.24 This element would attempt to limit private use to those days the private use was incidental to or necessary to the income-earning use. An objective test of this nature is similar to a bright-line test, based on private use. In order for an owner to qualify for generous deductions, the private use of the asset is restricted to a minimum.
- 4.25 An example of private use that is merely incidental or necessary to the income-earning use would be when the owner stays in his or her holiday house for a couple of days carrying out repairs and maintenance to enhance the income-earning potential of the house.
- 4.26 A private use restriction along these lines would clearly limit private use substantially. Consequently, the same incentives exist as with a bright-line test for owners to understate their private use of the asset, or to treat all private use as incidental or necessary to the income-earning use. Private use of this nature is arguably not private use at all. There are also definitional problems associated with this test, such as the ambiguity surrounding the term “incidental use”.

***Private use of the asset did not conflict with income-earning use***

- 4.27 This element would limit deductions for those owners whose private use of the asset conflicted with income-earning use.
- 4.28 This element attempts to discover the intention of the owner in holding the asset. If the private use of the asset conflicted heavily with, or took precedence over, the income-earning use, then this is a strong indication that the owner’s purpose in holding the asset is predominantly private rather than income-earning.
- 4.29 This element would require an analysis of the times the asset was used for private purposes, and whether that private use is likely to have conflicted with income-earning use.

**Example**

John owns a summer holiday home. The most popular and profitable time to rent out the home is over Christmas and New Year and John receives many offers to rent the home over this period. However, John does not accept these offers, as he wishes to reserve this time for his family and friends to enjoy.

- 4.30 This is an example where private use of the house clearly conflicts with the income-earning use. If this element was to form part of the test John would not be able to claim a higher level of deductions
- 4.31 In practice, determining what periods are the significant income-earning times may be difficult for some assets, as there may be uncertainty over when peak times start and finish. However, some basic generalisations can be made – for example, the ski season is the peak time for a ski chalet and the summer months are the peak time for beach-front holiday homes.
- 4.32 Furthermore, this element could create some uncertainty over when private use of the asset would conflict with income-earning use. An example would be when a holiday home has not been booked for income-earning use for a week over summer and the owners decide to use the house for their private enjoyment. However, after arriving at the house the owner is contacted requesting a booking for that week. If the owner denies the new booking and carries on with the private use of the house, would this be seen as private use conflicting with income-earning use? To cover this situation, this element may have to contain the concept of “reasonable notice”.

***Whether the receipts derived from the asset exceed the expenditure***

- 4.33 This element looks at the receipts derived from a mixed-use asset and whether they exceed out-going expenditure. If receipts are larger than the expenditure, this may indicate that the owner had an income-earning focus and therefore the owner could be allowed to claim a higher amount of deductions.
- 4.34 The advantage of this element is that it is simple to apply because the owner would only need to calculate whether the income raised from the asset exceeded the expenditure associated with it. The owner is already required to gather this information for income tax purposes.
- 4.35 The main disadvantage of this element is that different results may arise for similar or even identical assets, depending on decisions made by owners about matters such as funding or maintenance costs. For example, an owner who borrowed heavily in order to purchase a holiday house is less likely to have income exceeding expenditure compared with a lower-leveraged holiday house owner, because of the high interest costs. Furthermore, owners may be able to structure their funding between mixed-use assets and other assets they hold to ensure that income exceeds expenditure by the smallest possible amount, to maximise their claim for deductions.
- 4.36 Finally, this objective element does not accommodate situations when the asset is unable to achieve its full income-earning potential. This might happen if, in a particular year, expenditure on an asset exceeded the incoming receipts because it was taken off the market to undergo repairs and maintenance (which would both reduce the scope for earning income and increase expenditure).

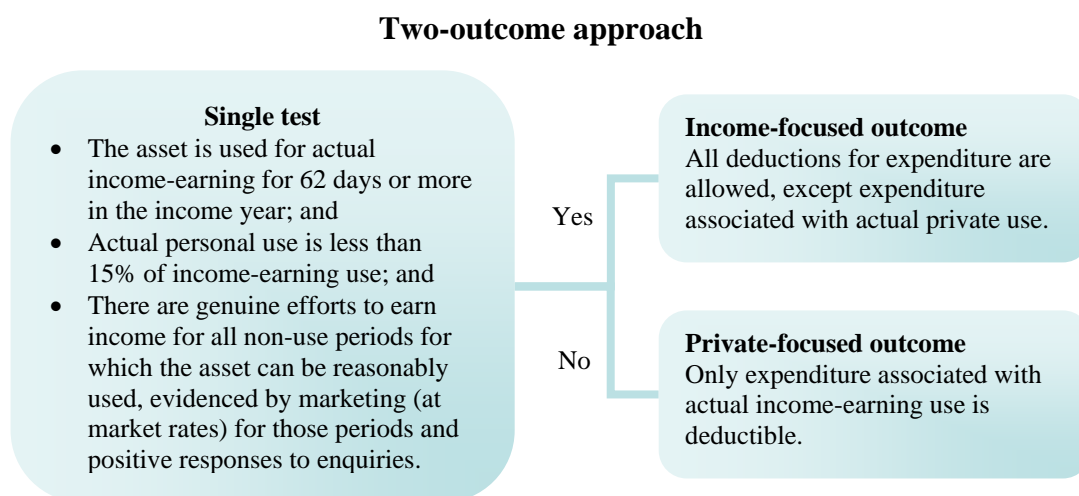
## The proposed test(s)

4.37 From the various elements above, a test or tests can be constructed that distinguish between the different possible outcomes discussed in Chapter 3, and prescribe an appropriate level of deductions. No one element would fully achieve this objective as the elements have particular advantages and disadvantages. Consequently, a combination of different elements is proposed.

## Two-outcome approach

4.38 The two-outcome approach uses a single test that identifies whether an owner is income-focused and able to claim all deductions except for expenditure that is attributable to actual private use. An income-focused owner is likely to be an owner whose dominant purpose is to rent out the asset, and private use of the asset is minimal. If the owner fails the test, the owner will only be able to claim expenditure that is attributable to actual income-earning use (this is referred to as a private-focused outcome).

4.39 The proposed test comprises three of the elements discussed previously. The basis for including each element is discussed below. The proposed test, which would apply to each income year, is described in the following diagram:



### *Income-earning use bright-line element*

4.40 The test contains two bright-line elements. The first of these requires that the asset be used for actual income-earning use for 62 days or more in a year. The 62 days of income-earning use is an attempt to approximate the average income-earning potential of a range of mixed-use assets in New Zealand, for an owner was genuinely serious about earning income from that asset and made genuine efforts to that effect. For example, if an owner of a summer holiday home went to a reasonable amount of effort, and the property was genuinely attractive as a summer holiday home, it is reasonable to assume that the property could be rented for at least 62 days over the summer period.



- 4.41 In the context of satisfying the income-earning threshold, a day of actual income-earning use is any day the asset is used by a third party and market rates are paid.
- 4.42 Generally, officials consider that prescribing a reasonably significant income-earning threshold is justified given the high level of deductions an asset owner receives if they pass the test. Submissions are welcome on whether 62 days is an appropriate threshold. It should be noted, however, that the various elements in the proposed approaches should be viewed as a package. Therefore, any changes to particular elements may warrant related changes to other elements or the addition of another element.

*Private use bright-line element*

- 4.43 The second bright-line test requires that personal use is less than 15 percent of income-earning use. This threshold has been set relatively low to appropriately target the income-focused group. That is, if the owner's dominant purpose is to rent out the asset, it is reasonable to expect that the private use of the asset will represent a low proportion of actual use. Furthermore, given the high level of deductions that owners can receive if they fall within the income-focused outcome, it is reasonable to limit private use to a low proportion of income-earning use.
- 4.44 In the context of satisfying the private use threshold, a day of actual private use is any day a mixed-use asset is used or is reserved for use by the owner or an associated person of the owner. This is a necessary requirement in order to prevent owners from understating their private use of the asset in order to gain higher deductions.
- 4.45 An issue that requires further consideration is how the use of the asset by associated persons in return for market rent should be treated. For example, an owner rents her holiday home to her brother at market rates over the summer holidays. A reasonable argument can be made for treating this period of rental as income-earning use and not private use. That is, the owner will be taxed on the rental income in the same way as if she had rented the home to a non-associated third party, and the owner is not obviously receiving a private benefit from renting the home to her brother. On the other hand, there are examples where it would be clearly inappropriate to count the period an asset is rented to an associate as income-earning days. For example, a husband rents his holiday home to his wife for market rent.
- 4.46 This is a difficult area and submissions are welcome on an approach that reflects these concerns but is still able to be applied with a reasonable degree of certainty.

*Active and regular marketing*

- 4.47 The final element of the test is that the owner must have gone to genuine efforts to earn income for all non-use periods for which the asset can be reasonably used. This should be evidenced by marketing for those periods and a positive engagement with enquiries. This element is essential

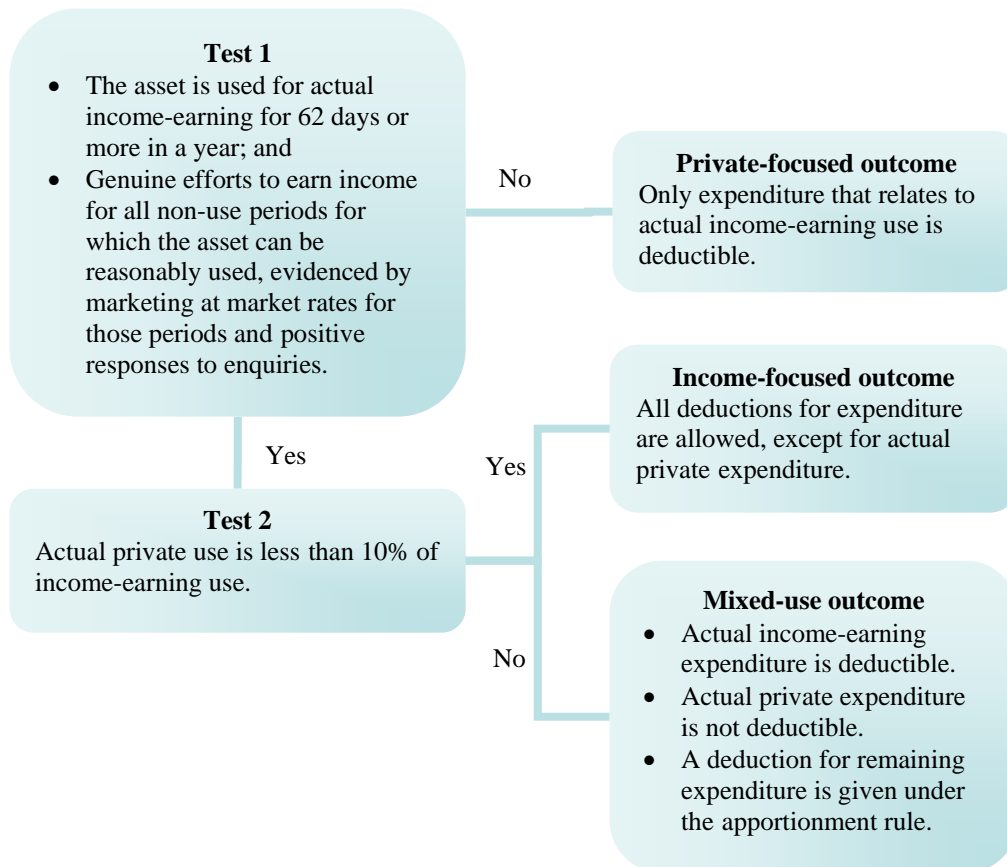
as an owner is unlikely to have the dominant purpose of earning income from an asset if the owner did not advertise the asset.

4.48 The term “reasonable” has been used in this element as an acknowledgment that it is unreasonable to require owners to advertise the asset in all non-use periods, as in certain circumstances the asset may not practically be able to be used for income-earning purposes. For example, it would not be reasonable for an owner to seek to rent out a yacht for a period when the yacht has been taken out of the water for de-fouling.

### Three-outcome approach

4.49 The three-outcome approach requires two tests. The first test identifies assets where the focus is on private use, and the second test distinguishes between assets where the focus is on earning income and those which are genuine mixed-use assets. The proposed two tests are as follows:

### Three-outcome approach



### *Test 1*

- 4.50 Test 1 contains two elements. The first is a bright-line element, setting a minimum level of income-earning use at 62 days in a year. The second element requires that the owner make genuine efforts to earn income for all non-use periods for which the asset can be reasonably used, evidenced by marketing for those periods and positive responses to enquiries. If the owner does not satisfy either element, the private-focused outcome will apply.
- 4.51 These elements are also features of the two-outcome approach and, the same advantages and disadvantages apply. In addition, the definition of an actual income-earning use day would be the same.

### *Test 2*

- 4.52 If the use of the asset successfully meets the first test, the owner is required to apply the second test. The second test determines whether the income-focused or mixed-use outcome should apply. This test contains one bright-line element that limits private use to less than 10 percent of income-earning use. If the asset passes this test (and also passes all the elements in test 1) the asset will be subject to the income-focused outcome. If this test is failed the asset is treated as a genuine mixed-use asset and expenditure for non-use periods is apportioned (the apportionment formula is explained in Chapter 3).
- 4.53 The second test is intentionally a difficult test to satisfy. This test should capture only those assets used predominantly for income-earning purposes and therefore attracting the highest amount of deductions. However, it is acknowledged that many income-focused assets may still have a small amount of private use – often associated with the income-earning use. Consequently test 2 allows a small amount of private use.

### ***Proposed test(s) summary***

- 4.54 The primary objective of the three-outcome approach is similar to the two-outcome approach – namely, simplicity and certainty. However, the three-outcome approach recognises that some assets may be used for genuine mixed-use purposes and therefore their owners should be able to apportion the expenditure incurred that relates to periods the asset is not used.

### **Application of proposals – The Johnston family example**

- 4.55 The Johnston family owns a holiday home in the Coromandel. In the 2013 tax year the family actively marketed the house at market rates in newspapers and on internet sites. The house was rented out for 95 days in that year. The Johnston family also used the holiday home themselves for fourteen days over seven weekends during the year.

4.56 The Johnston family incurred a total of \$10,000 of expenses in that year. These expenses can be split into three amounts:

- \$2,500 – directly attributable to the income-earning use of the house.
- \$500 – directly attributable to the family’s private use of the house.
- \$7,000 – attributable to the time when the house was empty.

4.57 The total amount of expenses that the Johnston family will be able to claim will depend upon whether the two-outcome or the three-outcome model is applied.

***Two-outcome approach***

4.58 Under the two-outcome approach, the family will satisfy the test, as outlined in the following table:

Elements of the test	Pass or fail
The asset is used for actual income-earning use for more than 62 days in the income year.	<b>Pass</b> – the asset was used for actual income-earning for 95 days in the year.
Actual personal use is less than 15% of income-earning use.	<b>Pass</b> – the asset was used for private purposes for fourteen days in the year (private use was 14.74% of income-earning use).
There are genuine efforts to earn income for all non-use periods for which the asset can be reasonably used, evidenced by marketing (at market rates) for those periods and positive responses to enquiries.	<b>Pass</b> – the family actively marketed the asset.

4.59 Since the family satisfies all the elements in the test, the family is able to claim both the \$2,500 of expenses that was directly attributable to the income-earning use of the house, and the \$7,000 of expenses that was attributable to the time when the house was empty – totalling \$9,500 of allowable deductions.

4.60 However, if the family had chosen to use the holiday home for another weekend, raising their private use to sixteen days, the family would not satisfy the test (private use would be 16.84% of income-earning use). In this situation, the family would only be able to claim the \$2,500 of expenses that was directly attributable to the income-earning use of the house.

### *Three-outcome approach*

4.61 Under the three-outcome approach the family will satisfy the first test and fail the second test, as outlined in the table below:

<b>Elements of the two tests</b>	<b>Pass or fail</b>
<b>Test 1</b>	
The asset is used for actual income-earning use for more than 62 days in the income year.	<b>Pass</b> – the asset was used for actual income-earning for 95 days in a year.
There are genuine efforts to earn income for all non-use periods for which the asset can be reasonably used, evidenced by marketing (at market rates) for those periods and positive responses to enquiries.	<b>Pass</b> – the family actively marketed the asset.
<b>Test 2</b>	
Actual private use is less than 10% of income-earning use.	<b>Fail</b> – the asset was used for private purpose for fourteen days in a year (private use was 14.74% of income-earning use).

4.62 Since the family satisfies the first test and fails the second test, the family will be able to claim the \$2,500 of expenses that was directly attributable to the income-earning use of the house, and apportion the \$7,000 of expenses attributable to the time when the house was empty using the apportionment formula:

$$\text{Unused time expenditure } (\$7,000) \times \frac{\text{Actual income-earning use (95 days)}}{\text{Actual income-earning use (95 days) + Actual private use (14 days)}} = \text{Deductions } (\$6,101)$$

4.63 Under the formula, the family is able to claim \$6,101 of the total expenses attributable to the time when the house was empty. Therefore, the family is able to claim \$2,500 of direct expenses plus \$6,101 of apportioned expenses equalling total allowable deductions of \$8,601.

### **Submission points**

- Are there any more useful and relevant elements within the tests that should be considered?
- Do the suggested tests represent a significant compliance burden?
- Do the suggested tests produce equitable outcomes?
- Is the 62-day income-earning use threshold achievable for the majority of mixed-use assets?
- Is a single bright-line threshold based on the average income-earning potential of a number of different mixed-use asset (62 days), supported by other elements, preferable to a number of different bright-line thresholds for different types of mixed-use asset, without any supporting elements?
- Bright-line tests based on income-earning and private use are relatively simple to apply and offer certainty. However, they can lead to arbitrary results. Would a more complex test that accommodates extenuating circumstance be a better approach and, if so, what should the test(s) look like?
- How should the use of the asset by an associated person in return for market rent be treated – private use or income-related use?
- Overall, which approach is preferred?

## CHAPTER 5

### Assets subject to the suggested new rules

- 5.1 This chapter evaluates a number of alternative approaches to legislatively prescribing the group of assets to which the proposed new rules should apply.

#### Typical mixed-use assets

- 5.2 The most common type of asset used for both income-earning and private purposes is the holiday home.
- 5.3 The expression “holiday home” is used here to mean residential property which is occupied on a short-term basis by people who are on holiday or on a weekend break or for any other reason. Holiday homes are also typically not occupied for a part of the year. The use of many holiday homes will be seasonal. Holiday homes that are near a beach or some other location where the focus is on warm-weather activity will typically be used much more in summer than in winter months, whereas other holiday homes may be located near a ski field and so predominantly used in winter months. Other properties may see year-round use, such as those located in city centres, or near places which provide activities that are less weather-dependent, such as vineyards. City-centre apartments may be rented by people travelling on business, as well as those on holiday.
- 5.4 The renting out of holiday homes when they are not being used by the owners has been facilitated in recent years by the advent of internet sites where people can list their holiday home. At present, there are around 15,000 privately held holiday homes advertised on the eight leading New Zealand websites. This development has been accompanied by an increase in the number of professional managers who deal with the “on-site” tasks required to facilitate renting holiday homes for absent owners.

#### Other assets

- 5.5 Holiday homes will represent the majority of assets used both privately and for income-earning purposes. However, there are other assets that are also used in this way.
- 5.6 A number of businesses advertise management of yacht charters, providing a similar service to private yacht owners to that which property managers provide to owners of holiday homes. These yacht charter businesses advertise and organise charters of yachts which are privately owned, and pay a proportion of the charter fee to the owners of the yachts.
- 5.7 Some light aircraft will also be used privately and rented out, and there will inevitably be instances of other assets used in this way.

## **Defining what assets the rules will apply to**

- 5.8 While holiday homes represent the majority of mixed-use assets (at least by value), the core provisions of the Income Tax Act deny deductions for private use for all kinds of assets, not just holiday homes.
- 5.9 Efficiency and fairness issues also arise. To avoid distortion of investment and spending decisions, the tax system should, where it is possible and pragmatic, provide the same treatment for all types of mixed-use assets, rather than different treatments for different kinds of mixed-use assets.
- 5.10 The question therefore arises as to which assets the proposals in this paper should apply. There are a number of different options, which are discussed below.

### ***Option 1 – list of assets***

- 5.11 One possible approach would be a schedule of assets, which would list assets by type, such as holiday homes, boats, aircraft and any other assets that it is appropriate for these rules to apply to. To ensure certainty was achieved, this list would probably need to be in a form with a clear legal status. This could be achieved by including the list in the legislation, a regulation, or perhaps a determination issued by Inland Revenue.
- 5.12 A list would reduce some compliance costs, as only taxpayers who owned an asset which appeared on the list would need to consider the new rules. It would also allow the new rules to be deployed on a targeted basis – they could readily be made to apply only to those kinds of assets where it is considered that their application was warranted. A targeted approach is appropriate where complex rules are created, because the compliance cost of complex rules should only be incurred when justified by the revenue collected or the need to create an efficient or equitable outcome.
- 5.13 However, such a list would give rise to several problems:
- Inequitable results. People who owned assets that were not on the list would receive a different treatment from assets that were on the list.
  - Compliance costs and uncertainty arising from boundary issues. For example, if “holiday homes” were on the list, would the rules apply to a houseboat, an empty beachfront section or a caravan in a commercially run campground?
  - The need to update the list when new assets to which the rules ought to apply are identified. Constantly updating a list adds complexity for Inland Revenue and asset owners, particularly for the latter as updates would inevitably result in different application dates for different assets.
  - Applying the rules only to selected assets conflicts with the important “broad base, low rate” principle which guides policy decisions throughout the tax system. That principle discourages having different rules for different kinds of assets or activities when the underlying economic substance of the activity is the same.



- Owners of all kinds of assets need to apply some kind of apportionment rules to determine their entitlement to deductions under the Income Tax Act’s core provisions. This occurs regardless of whether the asset appears on a list. Consequently, it is not clear that a significant compliance cost saving is achieved by omitting some assets from these proposals.

5.14 Officials do not consider that the proposed rules are so complex that it would be necessary to limit their application to only a restricted group of asset owners. It is acknowledged however, that there is a difference in complexity between the two-outcome and three-outcome model.

***Option 2 – a minimum-value threshold***

5.15 Under a minimum-value threshold approach, all assets would be included in the rules if their value (or perhaps their cost) exceeded the specified amount.

5.16 The advantage of a threshold is that it allows a trade-off to be made between the compliance cost of applying the rules and the correct tax outcome. A threshold would also enable “high value” assets to be targeted without the range of potential inequities and complexity that specifying individual asset types would result in. Low-value assets such as computers, where the deduction at issue might be a few hundred dollars of depreciation, could easily be excluded.

5.17 However, a threshold rule can be complex in application and can give rise to problems. These might include:

- The decision to use cost or market value as the base. Market value is the most equitable, but has a compliance cost implication for assets other than real property for which the local authority rating value could be used. Cost is simple, but can lead to inequitable results between two owners of similar assets where one acquired the asset recently and the other has held it for a very long time.
- Whether tax depreciation, or some other progressive fall in value over time, should be recognised.
- If cost is used, how improvements to the asset should be factored in.

***Option 3 – no limit to application***

5.18 There are strong arguments, around equity and the obligation on all taxpayers to calculate deductions using robust methodology, for applying the new rules to all types of assets regardless of their value.

5.19 However, some compliance cost concerns remain. If the new rules were to apply to assets regardless of value, a person who owned a computer could end up being required to record their days of income-earning and private use for the purposes of apportioning a depreciation deduction of a few hundred dollars.

5.20 One way of managing compliance costs in this instance might be to apply the following rules:

- allowing expenditure which relates solely to income-earning (such as the installation of software below the value required to be capitalised and used solely for income-earning purposes) to be deductible in full;
- continuing to deny a deduction for expenditure which relates solely to private purposes (such as game software); and
- allowing the taxpayer to claim the appropriate proportion of mixed-use expenditure (such as annual depreciation) only if he or she applied the new apportionment rules. If the taxpayer chose not to apply the apportionment rules, no deduction for mixed-use expenditure could be claimed.

5.21 While this approach forces people to make the trade-off between incurring compliance costs and losing their tax deduction, it is relatively harsh.

#### ***Option 4 – conceptual definition of assets***

5.22 This approach would provide a conceptual definition of the assets to which the new rules would apply. Assets would be identified that are the most likely to give rise to outcomes under current law which are arguably unfair. The following criteria could be used:

- The asset is rented on a short-term basis only. This would target the key assets which give rise to concerns, such as holiday homes, yachts and aircraft. This would leave out assets where the current law in this area is working reasonably well, such as long-term residential rentals. In the case of residential property, the Residential Tenancies Act 1986 does not apply to temporary or transient accommodation such as hotels and motels ordinarily provided for periods of less than 28 days at a time. This concept may be a useful way of excluding some assets from the suggested new rules.
- The asset is unused for a specified minimum proportion of the year. As noted in earlier chapters, difficult deduction questions only arise for expenditure which is not readily attributable to (or able to be apportioned between) income earning use and actual private use. If a person owns an asset which is actually used for all (or almost all) of the time, no difficult questions of allocation of expenditure arise, so there is no need for the new rules to apply.
- The asset is actually used privately.

#### **Analysis and suggested approach**

5.23 While a list of assets has some attraction, it may be considered too arbitrary. A threshold has some merits, but if used on its own would invariably be complex. Applying the proposed new rules to all assets is conceptually

attractive. However, we think the required record-keeping obligations may not be justifiable for low-value assets.

- 5.24 Officials' recommendation is that the conceptual definition of assets be used. It enables the assets where significant deductions are at issue, primarily holiday homes, to be targeted. It will also encompass other mixed-use assets without the need to maintain a list, and so avoid the inequities and compliance costs that would result from not all assets being on the list.
- 5.25 The first element of the conceptual definition is that the asset is rented on a short-term basis. The Residential Tenancies Act concepts are referred to above in the context of holiday homes. For boats, rental on a daily basis may be the appropriate measure, and for aircraft, perhaps hourly.
- 5.26 The second element of the conceptual definition is that the asset is unused for a reasonable proportion of the year. Officials suggest that a total of two months non-use in any 12-month period ending in the tax year is a reasonable threshold (although submissions are invited on this point). Where assets' non-use periods fall below two months, owners could have the option of applying the new rules.
- 5.27 It is suggested that the conceptual test be bolstered with a minimum-value threshold test for assets other than land, notwithstanding officials' concerns about such a test. While compliance costs of the new rules are not expected to be significant, a simple threshold test would ensure that the rules were not applied at a level if the revenue at stake or the distortionary effect is insignificant.
- 5.28 To ensure that the threshold test did not become unduly complex, the rules could be based on the cost of the asset used for tax depreciation. This would provide a mechanism for recognising improvements to the asset because they are required to be added to the cost price for tax depreciation purposes. However, a taxpayer whose asset fell below the threshold would be free to apply the rules. A taxpayer whose asset fell below the threshold and who chose not to apply the rules would not be denied a deduction, but would need to make a case under general law.
- 5.29 Excluding land from the threshold test would mean that it would not need to be considered by the owners of holiday homes. Excluding land also avoids some of the difficulties which arise mostly with land, such as low acquisition costs being significantly different from market value due to the asset having been acquired some time ago and then appreciating in value.
- 5.30 Officials propose a threshold of \$50,000, comprising the cost of the asset plus any improvements required to be added for tax depreciation purposes. The \$50,000 threshold should not be reduced by tax depreciation. Asset owners who fell below the threshold could apply the rules on a "safe harbour" basis. Submissions are invited on these proposals.

### *Exclusions from the proposed rules*

5.31 Consistency across the tax system is important, but should not be pursued at all costs. Accordingly, when there are existing rules in place which deal adequately with assets used for both private and income-earning purposes, we propose that these rules should remain in place and the new rules should not apply. The following areas are already dealt with by their own set of rules:

- Motor vehicle logbook rules. These apply to the motor-vehicle expenses of a sole trader, the partners of a partnership and the shareholders of a look-through company when a motor vehicle is used both privately and to earn income.<sup>3</sup>
- The established practice around the use of part of a home for earning income.

Both of these sets of rules and practices set out very similar concepts for apportionment of expenditure.

5.32 The motor-vehicle logbook rules allow a deduction for motor vehicle expenses which is the proportion calculated by dividing business mileage by total mileage. Most motor vehicles will not meet the test set out above of not being used for an aggregate of two months in any year. However, to ensure compliance, it would be necessary to monitor use. Officials do not think such monitoring is warranted, so would suggest that motor vehicles be expressly excluded from the proposed mixed-use asset rules.

5.33 The home-use expenses rule is an Inland Revenue-accepted practice derived from *CIR v Banks* (1978) 3 NZTC 61,236. Accepted forms of calculation include both a calculation which divides the total area of the home by the area of the space used for income-earning purposes, and a calculation apportioning expenditure by the number of days the home is used for income-earning purposes in a year.

5.34 Both the motor-vehicle logbook rules and the home-use expenses rules apply the same methodology proposed for the genuine mixed-use asset outcome discussed in Chapter 4.

5.35 Comparable assets used by shareholders or shareholder/employees that are subject to fringe benefit tax, or treated as giving rise to a taxable distribution, or income, are dealt with in Chapter 6.

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<sup>3</sup> Subpart DE of the Income Tax Act 2007.

**Submission points**

- Is the conceptual method the best way to define the assets to which the new rules should apply?
- Do you agree with the proposal to have a non-use threshold as part of the conceptual method? Is two months of non-use in the income year right level?
- Do you agree with the proposal to have a threshold as a supplement to the conceptual method? Is \$50,000 the right level? Do you agree with the proposal to calculate it using cost plus any improvements required to be capitalised?
- Do you agree with the proposal to leave existing rules in place for assets such as motor vehicles and use of part of the home for earning income? Are there any other areas where existing rules deal with private use that the proposals should not apply to?

## CHAPTER 6

### Entities subject to the suggested new rules

- 6.1 For simplicity, previous sections of this paper have described assets in individual ownership. However, if the new rules were to apply to one kind of entity and not another, some asset owners might be incentivised to move their assets into entities where the new rules do not apply.
- 6.2 Assets held in entities purely for tax reasons rather than commercial reasons create additional costs in setting up and running those entities, reduce the revenue collected, and create unfair differences between those who use tax-advantaged entities and those who do not.
- 6.3 Entities used to hold mixed-use assets are likely to be those which are simple and straightforward to set up and operate, and are able to be easily controlled by one individual, or a small group of connected individuals – typically members of the same family.
- 6.4 The following entities and structures are considered in this chapter:
- partnerships
  - trusts
  - companies.
- 6.5 The proposals set out in this chapter rely heavily on the “associated persons” rules to define when an asset is being used for private purposes (as does the core rule when the asset is owned by an individual).
- 6.6 The associated persons rules provide an efficient and ready-made tool to identify relationships, typically between the owner of an asset and the person who uses the asset, which are very likely to mean that the use of the asset is for private, rather than income-earning reasons. Further information and examples of the associated persons test can be found in Inland Revenue’s Tax Information Bulletin at [www.ird.govt.nz/technical-tax/legislation/2009/2009-34/2009-34-taxation-act-2009/2009-34-associated-persons/](http://www.ird.govt.nz/technical-tax/legislation/2009/2009-34/2009-34-taxation-act-2009/2009-34-associated-persons/)

#### **Partnerships (including limited partnerships)**

- 6.7 A partnership is simply more than one individual or other entity carrying on a business together with a view to a profit (with different roles allocated to some of the partners in a limited partnership). Partnerships are easy to set up and are controlled by the general partners, so are the kind of structure which might be used to hold a mixed-use asset.

### *Current tax law*

- 6.8 A partnership is not a taxable entity. As a general rule, partners record their share of the partnership's income and expenditure in their own tax returns. The requirement for the expenditure to relate to income earning or a business (nexus test) and the private limitation will apply to each partner separately.
- 6.9 When an asset is used by Partner A, the private use limitation is not considered to apply to deny a deduction for Partner B, but the nexus test will not be satisfied so Partner B will not be entitled to a deduction for expenditure relating to that private use anyway. Overall, however, the same fundamental issue arises here as it does for individuals – uncertainty over the ability to claim deductions for assets which remain unused for some portion of the year.

### *Suggested approach*

- 6.10 It is suggested that the new rules apply to assets owned by partnerships. Private use will exist when the asset is used by any partner. Consistent with the treatment of property owned by individuals, the associated persons test in section YB 4 of the Income Tax Act 2007 should apply to extend the concept of private use where the asset is used by someone associated with a partner.
- 6.11 If a threshold test is to be used to determine which assets are subject to the proposals, the threshold should be applied to the aggregate of all partners' interests, to avoid creating a situation where the rules can be avoided by holding an asset in a partnership of family members.

### **Trusts**

- 6.12 A trust is a legal relationship where a trustee has ownership of assets, but is subject to legal obligations in favour of others. In a formally constituted trust, these obligations are set out in a trust deed, which typically either names individual beneficiaries (for example, John and Jane Jones) or describes them by class (for example, the children and grandchildren of Arthur Jones).

### *Current tax law*

- 6.13 Under the current rules, the trustee can claim a deduction for amounts incurred in deriving taxable income.
- 6.14 In the context of a holiday home, deductions are available for expenditure incurred in renting the holiday home to third parties. If the holiday home is made available to beneficiaries, the nexus test applies to deny any deductions unless those beneficiaries were to pay for the use of the holiday home (and the trustee treated those amounts as income of the trust).

### ***Suggested approach***

- 6.15 One approach would be to apply the rules to all kinds of trusts. Whether the rules would in fact impact on a trust would then depend on whether the trust had assets which satisfied the asset test (described in Chapter 5).
- 6.16 Alternatively, the scope of the rules could be limited to entities which are the usual type of “family trusts”, as this is a common ownership structure for holiday homes in particular, and the kind of structure which existing holiday homes can readily be moved into.
- 6.17 Where the trustees of a trust are a “tax charity” as defined in the Income Tax Act 2007, they will generally not be entitled to claim deductions under the existing law, so the proposals in this paper will not affect them. However, to avoid any confusion it may be worthwhile to expressly state that any new rules do not apply to this kind of trust.
- 6.18 Other trusts could also be excluded, such as:
- trusts for the benefit of a local authority;
  - funeral trusts;
  - trust that are widely held, such as some registered superannuation funds; and
  - trusts where the settlor and the members of the settlor’s family are not entitled to benefit.
- 6.19 For the remaining trusts, private use should exist if the asset is used by any beneficiary, or settlor (defined in section HC 27), or any person associated with a beneficiary or settlor under section YB 4 of the Income Tax Act 2007.

### **Companies**

- 6.20 A number of issues need to be considered in the context of companies.
- 6.21 Unlike the other entities, existing rules already apply to companies to deal with the issue of company assets used by shareholders or shareholder employees. This kind of use is the equivalent of the “private use” concept discussed elsewhere in this paper. Detailed rules govern whether this use by shareholders and others should be treated as an in-kind dividend, a fringe benefit or as income of the recipient of the benefit.

### ***Which kinds of companies should the mixed-use asset proposals apply to?***

- 6.22 Not all companies meet the characteristic of a suitable entity to hold a mixed-use asset namely, being easy to set up and control by a single individual or a small group of connected individuals. This criterion will only be satisfied by smaller companies with a small number of shareholders, most of whom are connected. There are three existing types of companies in the Income Tax Act 2007 that are likely to have the characteristics described above. These are:



- look-through companies;
  - close companies; and
  - qualifying companies.
- 6.23 Detailed tests define each of these types of companies, but each can be very broadly summarised as requiring ownership or control by no more than five individuals. The detailed tests typically treat people with close family relationships as a single shareholder, so the number of nominal owners may exceed five.
- 6.24 Officials consider that, to the extent the new proposals are to apply to companies, they should only apply to companies which fall within one of the three definitions outlined above. These are existing, robustly designed and well-understood concepts which are designed to identify companies which, broadly, are controlled by a small number of individuals. Officials consider that using these existing concepts is preferable to creating a new definition of a company that should be subject to the proposed mixed-use asset rules.
- 6.25 This means that, for companies which fall outside these definitions, the suggested mixed-use asset rules will not apply and existing rules for deductions will continue to apply when assets belonging to the company are used by shareholders or their associates.

### ***Look-through companies***

- 6.26 Because look-through companies have entirely different tax characteristics from other companies, the analysis can be simplified by dealing with them separately.
- 6.27 The look-through company (LTC) rules started applying from 1 April 2011. Broadly, an LTC is a company with five or fewer ultimate natural-person owners who all elect that the company should be subject to the LTC rules. A company which has LTC status is tax-transparent from the point of view of the company's and the shareholders' income tax position, so the company's income, expenses, gains and losses are passed on to its shareholders and the company itself is not a taxable entity.
- 6.28 This means that the tax consequences of transactions involving an LTC are significantly different from that of other companies. For example:
- The company does not pay tax itself, but each shareholder pays a share of the tax which arises on the profits.
  - The dividend rules do not apply.
  - Section DA 1 of the Income Tax Act 2007, which allows a deduction only when expenditure is incurred in earning income or in carrying on a business will not allow a deduction for expenditure incurred in providing a benefit to shareholders – such as the use of a mixed-use

asset. This is the same approach which is taken to partnerships, and is not reliant on the private limitation.

### ***Suggested approach***

- 6.29 Shareholders of an LTC face the same question as partners in a partnership face in relation to mixed-use assets, which is the extent to which expenditure relating to non-use periods is deductible.
- 6.30 The approach suggested for partnerships earlier is to treat private use as any use of the asset by a partner or an associated person of a partner. In the context of an LTC, the equivalent is to treat private use as use by a shareholder or any person associated with a shareholder. Officials recommend that this approach be taken to LTCs, and note that because of the completely different tax rules that apply to LTCs compared with other companies, this suggestion is independent from the approach to companies discussed below.

### ***Exclusion for motor vehicles held by companies from the mixed-use asset rules***

- 6.31 The main type of asset owned by companies which is used for both income-earning and private purposes is motor vehicles. In the company context, the use by a shareholder of a motor vehicle will be subject to either the FBT or the dividend rules. Officials consider this outcome appropriate and do not propose to apply the new rules to motor vehicles owned by companies.
- 6.32 Exclusion of motor vehicles from the mixed-use asset rules for companies is consistent from an outcome perspective to their exclusion for other entities (where the motor vehicle logbook rules are suggested to remain in place).

### **Reconciliation of mixed-use asset rules with existing rules for taxing shareholder use of company assets**

- 6.33 In the sections above, it has been suggested that if the proposed mixed-use asset rules are to apply to companies, they only apply to the defined smaller companies, not larger companies, and that they not apply to motor vehicles. Specific suggested rules will apply for LTCs.
- 6.34 The remaining complexity is how the proposed mixed-use asset rules should be reconciled with the existing rules which tax the use of company assets by shareholders and their associates.

### ***Dividend rules***

- 6.35 If a company asset is used by a shareholder, the market value of that use is treated as a dividend. The amount of the dividend is reduced by any amount paid by the person receiving it. The purpose of these rules is to ensure that shareholders of companies cannot step around the rules which apply to cash dividends by taking value out of the company in a non-cash form. They recognise that any transfer of value from the company to its shareholders should attract the same tax consequences, regardless of the form that transfer of value takes.

- 6.36 The dividend rules require the shareholder to treat the value received as income, and the gross value of the use of the asset will be taxed at the shareholder's marginal tax rate. The company is obliged to pay withholding tax. The company is denied a deduction for the expenditure incurred in providing the dividend.

### ***FBT rules***

- 6.37 If the asset is used by a person who is a shareholder/employee, the company can elect to treat the use of the asset as a fringe benefit. Rather than treating the fringe benefit received by the employee as income, a fringe benefit tax (FBT) liability is imposed on the company. The rate of FBT payable by the company is designed to result in the similar amount of tax being paid as if the company had paid the employee a cash amount of an equivalent value.

### ***Income rules***

- 6.38 Under current law, accommodation provided in relation to employment or an "office" such as a directorship is treated as income to the recipient, and is not a fringe benefit.

### ***Analysis of existing rules***

- 6.39 While each of these sets of rules acts to create a tax charge for the use of assets by a shareholder or associate, they will give rise to a different tax consequence from the suggested mixed-use asset rules. This is for two reasons:
- Expenditure incurred in providing a benefit which is subject to income tax or FBT is generally considered to be deductible. If expenditure is incurred in providing a dividend, a deduction will not ordinarily be available for that expenditure (although it may be available if an amount is paid for use of the asset). Provided the asset is used in the business or to produce income, as well as being used by shareholders, a company is likely to treat expenditure relating to the period the asset is not used as deductible. This contrasts with the suggested mixed-use asset rules where the income-focused or genuine mixed-use outcome will limit deductions for periods of non-use.
  - Each of the three rules levies a tax liability on the recipient of the benefit, or in the case of FBT, levies a tax liability on the company which is equivalent to the amount of income tax the shareholder would pay on an equivalent amount of cash. This contrasts with the approach under the suggested mixed-use asset rules, as the person who uses the asset is not taxed on the value of the benefit received but is denied a deduction for expenditure relating to the private use.

### ***Options for dealing with mixed-use assets in companies***

- 6.40 There are potentially three ways to fit the suggested mixed-use asset rules in with the existing rules which apply to companies.

*Not applying the suggested mixed-use asset rules to assets held by companies at all*

- 6.41 The rationale for adopting this approach would be that the existing mechanisms already deal with the use of company assets by shareholders and associates, so there is no problem here which needs to be addressed. This approach is the simplest, and the most conservative from the point of view of leaving existing legislative mechanisms as they stand.
- 6.42 However, the tax consequences under the existing rules will be different from the tax consequences under the mixed-use asset suggestions. This might encourage some asset owners to move their assets into different entities, defeating the fairness objectives of the reforms proposed in this issues paper.

*Require companies to calculate deductions in accordance with the mixed-use asset rules, but leave the existing dividend, FBT and income rules in place*

- 6.43 Adopting this approach would require companies to apply the proposed new deduction rules to mixed-use assets. These will be situations when the dividend, FBT and income tax rules apply.
- 6.44 This approach applies the same limitation of deduction rules to companies as those which apply to other entities. Consequently, there is no incentive, from the point of view of maximising deductions, to shift assets from other ownership structures into companies, and at this level the outcome is “fair”.
- 6.45 However, the key difference is that the standard company rules (dividend, FBT and income tax rules) create a tax liability for the shareholder who receives the benefit of the use of the asset. (In the context of FBT, the liability arises in the company but is a proxy for the income tax liability the recipient of the benefit would otherwise bear.) This seems like a less attractive outcome to asset owners than that available under one of the other entities, where the deduction rules are the same but the benefit of the use of the asset is not taxed.
- 6.46 However, limiting the deduction and taxing the benefit is consistent with the scheme of shareholder and company taxation generally. If a company pays a cash dividend to a shareholder, it cannot claim a deduction for the cash paid, and the shareholder is liable for tax on the dividend received, although this conceptual double taxation may be relieved by imputation. Applying the mixed-use asset rules to determine deductibility where the benefit is treated as a dividend is entirely consistent with the treatment of other dividends.
- 6.47 Where the company has imputation credits which it can allocate to the shareholder, the additional tax charge borne by the shareholder will be limited to the difference between the company rate of 28% and (typically) the top individual rate of 33%. However, if the company does not have sufficient imputation credits, or the 5 percent difference is considered material, this approach gives rise to a greater overall tax liability than other types of entities, where the same deduction limitations will apply but no tax liability will arise for the person using the asset. In these instances this

difference will encourage people who control companies which hold mixed-use assets in companies to move those assets out of companies and into other forms of ownership.

*Require companies to calculate deductions in accordance with the mixed-use asset rules, and exempt the receipt of any such benefit by a shareholder or associate from the dividend, FBT and income rules*

- 6.48 If this approach were to be adopted, a modified version of the mixed-use asset rules would apply to companies, potentially limiting the deductions available. However, the use of the asset would no longer be income, a dividend, or a fringe benefit to the shareholder or associate – those rules would be “turned off” in instances where the mixed-use asset rules apply.
- 6.49 No additional tax liability would arise to the shareholder for receipt of the benefit, just as no tax liability arises (now, or under the proposals in this paper) where a person who owns a mixed-use asset directly uses it for their own benefit. The only tax impact would be the potential limitation of deductions.
- 6.50 However, “switching off” the key elements in the rules which deal with the distribution of value from companies delivers an outcome which is inconsistent with the taxation of companies generally. While concerns are unlikely to arise with the main category of mixed-use assets of holiday homes, clear boundary rules would be needed to ensure that companies could not use these rules to, for example, avoid paying FBT on assets such as yacht.

### ***Analysis and suggested approach***

- 6.51 The first approach, of leaving companies out of the rules altogether, would mean that companies will generally be entitled to greater levels of deduction than other entities. This means the fairness objectives of these rules are not achieved.
- 6.52 The third approach, of applying the new deduction rules to companies and “switching off” the dividend, FBT and income rules appears to align with other entities under the mixed-use asset rules, but creates an outcome which is at odds with the general treatment of distributions or other transfers of value out of companies. It is an attempt to provide non-company treatment to a company structure. A better approach for those who wish to hold assets in a company, but to be taxed as if they held them personally, is to use the look-through company structure. The look-through company rules are an existing policy framework designed to deliver exactly that hybrid between the corporate rules of a company and the tax treatment of individual (or partnership) ownership.
- 6.53 Officials prefer the second approach, of leaving the dividend, FBT and income rules in place but applying the new suggested mixed use asset rules to calculate deductions. While this would initially appear to give rise to “double taxation” of the benefit on the use of the fixed asset, it is akin to when a cash dividend is paid. As noted above, if the company has

imputation credits available, it can distribute those to the shareholder, and if distributed at the 28% tax rate, will mean that the additional tax liability borne by the shareholder is small and the incentive to move assets out of a company structure and into another entity is also small.

- 6.54 Earlier in this chapter it is noted that the dividend, fringe benefit and income rules can apply to different benefits. Different tax treatments may be preferred by different companies and shareholders, depending on matters like the availability of imputation credits in the company and the value to the company of the increased deductions which are available if an FBT or income tax treatment is applied.
- 6.55 Officials at this stage do not suggest any change to the rules which currently apply to determine which of these tax treatments is required to be used. Submissions are invited on this issue.

### *Companies – other matters*

- 6.56 Current tax laws allow companies to deduct interest which they incur essentially regardless of the purpose of the borrowing. This provision may need to be overridden by mixed-use asset rules which act to limit deductions.
- 6.57 A deduction is allowed for the interest cost incurred by those who borrow to purchase shares in a company. If the mixed-use asset rules were to apply to limit deductions within a company for the interest incurred in borrowing to purchase a mixed-use asset, an alternative structure might be for the shareholder to borrow the required funds, and use those funds to purchase the shares in the company. The company would have enough money to purchase the asset without any interest deduction. The shareholder would be entitled to a deduction for the interest incurred in borrowing money to purchase the shares in the company.
- 6.58 To ensure the mixed-use asset rules were not avoided in this way, a look-through rule would need to be implemented to limit an interest deduction claimed by someone who purchases equity or debt in a company which held a mixed-use asset, or when any company in a group of companies owned a mixed-use asset. This could be in a similar form to the existing rule which limits interest deductions for shareholders of qualifying companies who receive non-cash dividends.

**Submission points**

- Do you agree that, in order to ensure equitable outcomes, the proposed mixed-use asset rules need to apply to entities other than individuals?
- Are there any issues with the general use of the associated person's rules to determine when private use occurs? Are there any instances where this might be too wide a net?
- Do you agree with the recommended approach to mixed-use assets held by companies, which is to apply the rules which limit deductions but leave the dividend, FBT and income rules in place?
- Are there any circumstances when one of the dividend, FBT or income rules are not available for a benefit from use of a mixed-use asset, but should be?
- Do you think that there will be some movement of mixed-use assets out of companies and into other entities if these proposals are implemented?

## CHAPTER 7

### GST treatment of “available for use” periods

- 7.1 Tax cascades arise when a supplier of goods or services cannot recover the GST paid on the acquisition of goods or services. To prevent tax cascades the GST system provides a person with the ability to recover GST paid in respect of a supply when they acquire goods or services for business purposes or, in GST terms, “for making taxable supplies”. This ensures that the economic incidence of the tax is removed on most business purchases, and that GST taxes consumption and not production.
- 7.2 New GST apportionment rules were introduced on 1 April 2011. Under these rules, when a GST-registered person incurs an expense that was subject to GST, the person is able to deduct input tax on acquisition only to the extent to which goods or services are used for, or are available for use in, making taxable supplies.<sup>4</sup> In subsequent years, a person may be required to adjust the deduction claimed if the extent to which the asset is actually used for making taxable supplies is different from the intended taxable use of the asset. A number of exemptions are available to relieve a person from the requirement to make an adjustment if the amount of tax involved in the adjustment is minimal.
- 7.3 GST is imposed at a set rate on the value of a supply. The amount of GST involved in a supply therefore increases proportionally to the value of the supply. For high-value assets such as real property, it is particularly important to ensure that rules that regulate the ability to deduct input tax are clear in respect of the proportion of input tax that may be deducted.
- 7.4 Although for the most part such clarity exists, closer scrutiny is required when a mixed-use asset remains unused for a particular period. The GST issues for mixed-use assets are similar to those that arise for income tax which are discussed in the preceding chapters.

#### Application of the GST rules

- 7.5 To register for GST, either voluntarily under the \$60,000 registration threshold or compulsorily over the threshold, a person has to carry on a taxable activity. A taxable activity is defined in the GST Act as an activity carried out continuously or regularly and that involves supplying, or intending to supply, goods and services to someone else for a consideration but not necessarily for profit. Whether a person is carrying on a taxable activity is a question of fact and degree in each case and will involve an examination of all circumstances.

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<sup>4</sup> Some second-hand goods are not subject to GST on sale, but may still be treated as having GST imbedded in the purchase price. “Second-hand goods deduction” will be available in respect of those goods.



- 7.6 It is generally accepted that the requirement for a taxable activity to exist does not provide a high barrier to GST registration, thus allowing many taxpayers with a fairly small level of taxable activity to register for GST voluntarily. One benefit of this, and the related ability to deduct input tax, is that small businesses are able to grow and become more competitive. On the other hand, in mixed-use asset situations it is important to ensure that the level of input tax deductions is an appropriate reflection of the relative taxable and non-taxable use of the asset.

### The issues

- 7.7 The apportionment rules allow a person to claim input tax deductions to the extent that the goods or services are used for, or are available for use in, making taxable supplies.
- 7.8 In most cases, goods or services are *actively* used for either a taxable or non-taxable purpose or a combination of those purposes. In those cases, identification of the extent of taxable use of those goods or services can be based on the taxpayer's records of the asset's use for making taxable supplies.
- 7.9 In some cases, the goods or services may be available for use in, rather than being actively used for, making taxable supplies. For example, a commercial property developer may purchase raw materials that they intend to use in construction of a property at some time in the future. Although for a period of time the raw materials are not actively used for making taxable supplies, the property developer is still able to claim the related input tax deductions because the materials are "available for use" in making taxable supplies and will be actively used for that purpose at some time in the future.
- 7.10 In other situations, however, it may be difficult to determine the extent of taxable use of goods or services. For example, during a year, a holiday house may be used by its owners as a holiday residence for three months, be rented out<sup>5</sup> for five months, and be advertised for rent, but remain vacant, for the remaining four months. If the owner is registered for GST and the rental activity is subject to GST, a question arises over what extent the owner should be able to claim input tax deductions in respect of the house. Although there has clearly been taxable use for the five months when the property was actually rented out, it is uncertain whether the use in the period when the property was vacant should count towards the taxable use for deduction purposes.
- 7.11 The principal uncertainty stems from the fact that although the holiday house is available for use in making taxable supplies during the vacant period (because it is advertised as being available for rent), it is similarly available for use for private purposes during the same period.

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<sup>5</sup> Following the narrowing of the definition of "dwelling", effective from 1 April 2011, a supply of accommodation in a holiday house would normally be treated as subject to GST.

- 7.12 Neither current nor previous GST legislation has provided express guidance regarding the methodology that should be used for apportioning between taxable use and non-taxable use in these situations. One may argue that the availability of assets for use in making taxable supplies should take precedence and that input tax deductions should therefore be allowed in full for vacant periods. This is, however, difficult to justify as a default rule considering that private use can be the dominant reason for buying a holiday house. Instead, officials consider that the decision as to whether non-use of a holiday house should be treated as taxable use should be based on the dominant use of the asset during a relevant adjustment period.<sup>6</sup>
- 7.13 Officials view this methodology would produce a balanced outcome and provide a degree of protection to the revenue base. Certainty in the methodology used is desirable to enable taxpayers to comply with the legislation, to reduce their compliance costs in doing so, and to ensure consistent application of the apportionment rules across taxpayers.

### **Assets subject to clarification**

- 7.14 Chapter 5 discusses, in relation to the income tax rules, the types of assets used for mixed business and private purposes that should be covered by the new methodology. The introduction of a conceptual definition that would target assets where significant income tax deductions are an issue – such as holiday houses, boats and aircraft – has been recommended. To be covered by the proposed methodology, an asset must satisfy the following elements:
- the asset is rented on a short-term basis; and
  - the asset is unused for a reasonable proportion of the year; and
  - for assets other than land the cost is above a minimum threshold (possibly \$50,000).
- 7.15 It has also been suggested that the current rules in relation to logbooks for motor vehicles and established practice around the use of the part of a home for earning income would continue to apply.
- 7.16 The GST apportionment rules, as mentioned earlier, allow input tax deductions for goods and services that are not used for, but are available for use in, making taxable supplies. This treatment of non-use periods recognises that most goods or services are purchased by a GST-registered person for business reasons and will, at some point, be used for making taxable supplies. In these circumstances, the presence of an incidental private use may not unduly affect the deduction of input tax for the period of non-use.

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<sup>6</sup> Under the GST apportionment rules, an “adjustment period” is a period at the end of which a person must evaluate their taxable use of goods or services to ensure that a correct amount of input tax has been deducted. An adjustment period is generally a period of one year.

- 7.17 Some assets, however, have an inherently significant private element for which the application of the ordinary apportionment principles might not provide an appropriate outcome. Three key examples of such assets are holiday houses, private boats and aircraft. These assets are usually purchased by their owners with the intention of using them for private purposes and any commercial rental/hiring activity, at least in some cases, results from a desire to recoup some of the purchase price paid in relation to the asset rather than an intention to run a commercial operation.
- 7.18 These assets – holiday houses, boats and aircraft – account for the majority of assets that fall under the conceptual definition recommended for income tax purposes. To provide consistency between the taxes, one approach would be to adopt the conceptual definition for the purposes of GST.
- 7.19 The advantage of the conceptual definition approach is that it ensures that the same methodology is used for all assets that satisfy the relevant tests. The disadvantage of the approach is that it may be difficult to state with certainty which types of assets would be included under the definition. As a result, it may include some assets for which the methodology is not appropriate.
- 7.20 An alternative approach would be to apply the new methodology to holiday houses, boats and aircrafts only. Although this approach would provide taxpayers with certainty over application of the new rules, it may also exclude assets that are conceptually similar to those listed.
- 7.21 Officials seek views on which of these two approaches is preferable for GST purposes.

### **Possible approach**

- 7.22 In the context of assets such as holiday houses, boats and aircraft, input tax would either be incurred on the purchase of those assets or be embedded in the purchase price if the assets are second-hand goods.<sup>7</sup>
- 7.23 Taking into consideration the proposed income tax approach, in circumstances when an empirical determination of taxable use is not possible, such as when a mixed-use asset is not used in a particular period, it is reasonable to determine a preferred treatment by examining the total use of the asset during a relevant adjustment period.
- 7.24 A typical situation is where throughout a considerable part of an adjustment period a holiday house is used for making taxable supplies (that is, rented out), while its private use is minimal. In these situations, it seems fair to deem the time when the asset is not used, but available for use in, making taxable supplies as the time when the asset was actually being used for taxable purposes. The assumption is that the taxpayer would indeed have rented out the asset if they could.

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<sup>7</sup> If a purchase of land is zero under section 11(1)(nb) of the GST Act, a “nominated GST component” used for apportionment purposes (sec 23(3J)), will be 21D(2)(a)).

- 7.25 In a different scenario, an asset may be rarely used for making taxable supplies and much more often used for private purposes. In this scenario, we can conclude that the taxable use is merely incidental to the private use of the asset, and that the period of non-use should be treated in the same manner as a period of private use.
- 7.26 Finally, there will be situations when an examination of the overall activity of an asset might not provide a definitive answer on which use – taxable or private – has been predominant. In these circumstances, it may be reasonable to allow an apportionment of periods when the asset is not used.

### ***Three-outcome approach***

- 7.27 The above outcome would be achieved by adopting for an adjustment period a similar apportionment methodology to that described as the *three-outcome approach* in chapter 3 and chapter 4. The proposed approach requires a person to answer a number of questions about the use of their asset which are designed to provide an indication about whether the use of the asset, as a whole, is better classified as taxable, private or a mixture of the two.
- 7.28 The three-outcome approach would assist a GST-registered person to identify the extent of taxable use of those assets, as follows:

- *Predominant private use:* A person's taxable use of the asset will be limited to the periods when an asset is actually used for making taxable supplies. This would occur when the asset is not rented/hired out for more than 62 days in an adjustment period, and/or the person does not make a genuine effort to rent/hire out the asset during periods when the asset is not actively used (assuming that the asset can reasonably be used in those periods).

#### **Example**

A holiday is rented out for 30 days during a 12-month adjustment period. The house's taxable use for the adjustment period is 8 percent (30/365) and the owner may apportion the input tax in respect of the house accordingly.

- *Predominant business use:* A person's taxable use will include periods when the asset is actually used for making taxable supplies and periods when the asset was not used but available for use in making taxable supplies. This would occur when the asset is rented/hired out for more than 62 days in an adjustment period, and the person makes a genuine effort to rent/hire out the asset during periods when the asset is not actively used (assuming that the asset can reasonably be used in those periods), and the actual private use is less than 10 percent of the active taxable use.

**Example**

During a 12-month adjustment period, a holiday house is rented out for 120 days, used by the owners for private purposes for five days and advertised for rent for the remaining 240 days. Since the private use of the house is less than 10 percent of the rental use of the house, the person is able to treat the house as being used for taxable purposes for 360 days (120 + 240 days). The person's actual taxable use of the house during the adjustment period is, therefore, 98 percent (360/365) and the owner may apportion the input tax in respect of the house accordingly.

- *Mixed-use*: A person's taxable use will include periods when the asset is actually used for making taxable supplies and a proportion of time when the asset is not used, but available for use in making taxable supplies. This would occur when the asset is rented/hired out for more than 62 days in an adjustment period, and the person makes a genuine effort to rent/hire out the asset during periods when the asset is not actively used (assuming that the asset can reasonably be used in those periods), and the actual private use is 10 percent or more of the active taxable use.

The proportion of time that may be attributable to the use of an asset for taxable purposes during the time of non-use will be calculated by reference to the apportionment formula:

$$\text{Time not used} \times \frac{\text{Actual use for making taxable supplies}}{(\text{Actual use for making taxable supplies} + \text{Actual private use})}$$

**Example**

During a 12-month adjustment period a holiday house is rented out for 100 days, used by the owners for private purposes for 60 days and advertised for rent for the remaining 205 days.

The owner of the house may treat the 100 days that the house was actually rented out as use for making taxable supplies. The owner may also treat a proportion of the period when the house was vacant as use for making taxable supplies. This proportion is calculated using the formula:

$$205 \times 100 / (100 + 60) = 128$$

Therefore, the owner may treat 128 of 205 vacant days as attributable to making taxable supplies. In total, the house is being used 228 days (100 + 128 days) for taxable purposes during the adjustment period. As a consequence, taxable use of the house in the relevant adjustment period is 62 percent (228/365 days) and the owner may apportion the input tax in respect of the house accordingly.

7.29 Owing to the use of these “bright-line” tests, the three-outcome approach should not be too complicated or give rise to undue compliance or administration costs. At the same time, the three-outcome approach does provide for a variety of outcomes for identifying taxable use, therefore increasing the chance that the final outcome is suited to the individual circumstances of a taxpayer. On the other hand, a bright-line test will at the margins create differing outcomes for not dissimilar situations. This is an inevitable outcome of providing this kind of certainty.

### ***Two-outcome approach***

7.30 The second potential apportionment methodology suggested in Chapter 3 is the *two-outcome approach*. Depending on whether certain conditions are satisfied, under this approach a taxpayer may be deemed to either have been using or not have been using the asset for taxable purposes during the time of non-use. No apportionment of periods of non-use would be possible under this approach.

7.31 In the GST context, to be able to treat an asset as being used for taxable purposes during periods of non-use, the following conditions would need to be satisfied during an adjustment period under the two-outcome approach:

- The asset must be used for actually making taxable supplies (rent/hire) for more than 62 days in an adjustment period.
- Actual personal use must be less than 15 percent of active taxable use.
- Genuine efforts must be made to make taxable supplies for all non-use periods for which the asset can reasonably be used, evidenced by marketing for those periods and positive responses to enquiries.

7.32 By allowing only two-outcomes, this approach is simpler than the three-outcome approach. On the other hand, by either fully allowing or disallowing a period of non-use as use of the asset for taxable purposes, the approach may potentially provide an unfair or arbitrary result.

7.33 In the absence of an apportionment mechanism for non-use periods under the two-outcome approach, fewer taxpayers would be able to treat any proportion of non-use as being use for making taxable supplies than under the three-outcome approach. At the same time, some taxpayers would be able to claim the full period of non-use as use for making taxable supplies rather than being required to apportion that period.

### **Conclusion**

7.34 Either of the two approaches discussed in this issues paper in respect of deductibility of expenses for income tax purposes may potentially be adopted to resolve the uncertainty with the GST apportionment – at least, for holiday homes, boats and aircraft. Officials therefore seek views on these two approaches for GST purposes or whether there are other approaches that should be considered.

**Submission points**

- Do you consider that the methodology for treatment of periods of non-use should be the same for the purposes of both GST and income tax?
- How should assets subject to the proposed methodology be defined: conceptually or by list?
- Which of the suggested approaches (three- or two-outcome) is preferable for GST purposes?
- Are there any other approaches that should be considered?

## APPENDIX

### INTERNATIONAL APPROACHES

1. The issue of the deductibility of expenditure in relation to mixed-use assets is not a problem unique to New Zealand. Other countries have considered this problem and have developed rules that prescribe the amount of deductions owners of mixed-use assets can claim.

#### Australia

2. Australia's method of taxing mixed-use assets is almost identical to the current New Zealand rules – there is no specific regime that deals with mixed-use assets. Instead, the usual rules that regulate income and deductions apply.
3. A tax ruling (No. IT 2167) has been released by the Australian Taxation Office to assist owners of holiday homes in determining the tax status of rental income and their ability to deduct expenses. The ruling states that:
  - Deductions are disallowed in periods when friends or family rent out the asset, and the owner does not need to declare income from such activities.
  - Rent received from commercial letting, on the other hand, is assessable income and deductions for expenditure can be claimed in deriving that income.
4. However, deciding the amount of deductions for expenditure in relation to that income-earning use is the difficult question. In most cases the question should be determined in the light of previously decided cases. For example:

*In Case No. P116, 82 ATC 590 : Case No. 49, 26 CTBR (NS) 372, a property was let for 16 days during the year of income, occupied by the owners for 107 [days] and vacant for the balance of the year. Taxation Board of Review No. 1 apportioned the losses and outgoings attributable to the property on a time basis and allowed a deduction for the proportion that the property was let, i.e. 4.4%<sup>8</sup>.*
5. In general the approach in the above case should be followed in comparable situations - owners can deduct expenses on a time basis when the assets is being used for actual income-earning purposes and are restricted when the asset is being used for actual private purposes. However, if insufficient information is supplied, deductions will be limited to the rent received.
6. Deduction for periods when the asset is not being let out but is available for letting will depend upon the individual circumstances of each case. Evidence of whether active and bona fide efforts to let the property as a commercial rental were made during the relevant period will be taken into account.

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<sup>8</sup> Australian Taxation Office, Tax Ruling (No. IT 2167).



## **The United States**

7. The United States (US) has a set of rules that apply to certain assets that are used for both private and income-earning purposes.
8. These rules apply specifically to “dwelling units”. A dwelling unit is defined as basic living accommodation, including houses, apartments, condominiums, mobile homes, boats, vacation homes or similar property. However, a dwelling unit does not include a hotel, a motel or similar property that is regularly available for paying customers.

### ***Allowable deductions***

9. The amount of deductions owners of dwelling units can claim depends upon whether the use of the asset falls above or below certain thresholds. Three-outcomes are possible:

- The dwelling unit is regarded as being used purely for personal purposes if the asset is rented out for less than 15 days per year. In this situation, the owner is not required to include any of the rent as income and cannot deduct expenses.
- The dwelling unit is regarded as a home if the dwelling unit is rented out for more than 15 days, and the owner uses the asset for personal use for more than the greater of 14 days per year, or for more than 10 percent of the total days the asset is rented to others at a fair rental price. In this situation, the owner is required to declare rental income, and deductions for expenses are divided between the rental use and the personal use based on the number of days used for each purpose.

For example, an owner of a dwelling unit rents out the asset for 20 days and also uses the asset for personal enjoyment for 20 days in a given year. The amount of deductions the owner can claim is simply the income-earning use divided by the total use. In this scenario the owner can claim 50 percent of total expenditure (20 days / 40 days = 50%).

- The dwelling unit is regarded as a normal rental property if the personal use of the asset falls below either the 14 day or 10 percent personal-use thresholds and business use is greater than 15 days. In this situation, the owner is required to declare rental income, and can deduct expenses even when the property is vacant, provided it is available for rental.
10. Another important element of the US rules is that rental expenses that exceed rental income cannot be used to offset income from other sources. Instead, the loss can be carried forward to offset rental income from the next year.

### ***Rental use and personal use days***

11. Given the US regime relies heavily on private use and income-earning use days, the definition of private use and income-earning use days is very important.

12. Any day that the asset is rented at a fair rental price is a day of rental use even if the asset is used for personal purposes that day. However, any day that the asset is available for rent but not actually rented is not a day of rental use.
13. A day of personal use of a dwelling unit is any day that the asset is used by any of the following persons:
  - the owner or any other person who owns an interest in the asset;
  - a member of the owner's family or a member of the family of any other person who owns an interest in the asset;
  - anyone under an arrangement that lets the owner use some other dwelling unit; and
  - anyone at less than a fair rental price.
14. Any day the owner spends working substantially full-time repairing and maintaining (not improving) the property is not counted as a day of personal use.

## **Canada**

15. Generally, income from the rental of a mixed-use asset, such as a holiday home, will be treated as income from property. Canada treats rental income and deductibility of rental expenses in the same manner as Australia and New Zealand. For example, expenditure that relates to actual income-earning use is deductible, and expenditure that relates to actual private use is not deductible.
16. However, if the owner's rental expenses are consistently more than the rental income, the owner may not be allowed to claim a rental loss because the rental operation is not considered to be a source of income. Consequently, the Canadian approach requires the owner to have a reasonable expectation of making a profit from the rental activities.

## **United Kingdom**

17. The United Kingdom (UK) has a special tax regime for properties that are let as furnished holiday accommodation. In essence, owners with properties qualifying as "furnished holiday lettings" (FHL) are treated as carrying on a trade under the FHL rules, and are taxed under the rules applying to trade income rather than property income.
18. A "furnished holiday letting" is a property in the UK or the European Economic Area (EEA)<sup>9</sup> that is:
  - let out on a commercial basis with a view to a profit;

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<sup>9</sup> The current legislation only applies to properties situated in the UK; it was extended on a temporary non-statutory basis to EEA properties to ensure compliance with EU law. It will apply to EEA properties on a statutory basis from 6 April 2012 for individuals, and 1 April 2012 for companies.

- furnished (to at least the minimum level which an occupier would usually expect);
  - available for holiday letting on a commercial basis for 140 days or more during the year (increasing to 210 days with effect from 6 April 2012);<sup>10</sup>
  - actually let commercially as holiday accommodation for 70 days or more during the year, (increasing to 210 days with effect from 6 April 2012); and
  - not normally in the same occupation for more than 31 consecutive days.
19. Rent received from letting is regarded as taxable income and the owner can claim deductions for expenditure in deriving that income, including times when the holiday home was not in use, provided it was available for commercial use. However, the owner cannot claim a deduction for expenditure when the property is being used for personal purposes. Owners can also claim capital allowances on expenditure such as furniture, fridges, cookers, linen, cutlery and so on.
20. The main advantage of qualifying for “furnished holiday letting” (FHL) status was that, until changes made in Budget 2011 (which come into effect from 6 April 2012) it allowed owners to offset any loss arising from furnished holiday lettings against other taxable income, reducing the owner’s overall tax bill. This was in contrast to the usual treatment of losses arising from property letting under the property income regime, which could only be set against income from the same property-letting business. As a result of the changes announced in Budget 2011, from 6 April 2012, any losses arising from a qualifying UK or EEA furnished holiday-letting business can only be set against income arising from that same UK or EEA-furnished holiday-letting business; however, the rules for calculating profit/loss remain the same as those applying to trades, including the ability to claim capital allowances.
21. In addition, the FHL regime continues to allow certain capital gains relief, including business asset rollover relief, when the property is sold.

## France

22. The French also have a special tax regime in place for holiday accommodation. Like the UK regime, income from furnished lettings is treated differently from unfurnished lettings. The distinction is that the letting of furnished property is regarded as a business whereas the letting of unfurnished property is regarded as a civil activity.
23. Furnished lettings are treated for calculation purposes as commercial income. When total rental income before deductions is less than €32,000 (€30,000 if the property is let out as a “Gite” – French holiday home that is fully furnished and equipped for self-catering) taxable income can be calculated under a simplified deduction scheme. This scheme allows a deduction of 50 percent of

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<sup>10</sup> 1 April 2012 for companies.

gross income to be claimed, instead of the actual deductions. This is the default taxation scheme.

24. The primary purpose of this scheme is to simplify the taxation of furnished lettings. No expenses need be demonstrated, no accounts are required and no separate tax forms need be prepared. However, this regime always assumes a fixed taxable profit and never a lower profit or a loss.
25. If income is above the threshold, the owner is required to calculate actual expenditure related to the letting in order to calculate taxable income. If income falls below the threshold, the owner can still opt to calculate actual expenditure, however the owner is required to calculate actual expenditure for a minimum of two years. This option can be beneficial if a high level of expenses is expected.
26. If the property concerned is unfurnished, and the income from the property is below €15,000, the default scheme declares 70 percent of income is taxable. If income falls above this threshold the owner can opt to work out actual expenditure in order to calculate taxable income. Therefore, if actual expenditure is greater than 30 percent of income it is beneficial to work out actual expenditure.