The Treasury

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Release Document

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Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Mixed-use Assets

Date:	20 February 2012	**Priority:**	Medium
Security Level:	In Confidence	**Report No:**	PAD 2012/23 T2012/252

Action sought

	Action Sought	**Deadline**
Minister of Finance	**Discuss** with officials at the joint tax policy meeting on 28 February 2012. **Agree** to recommendations. **Indicate** whether the estimated revenue should be treated as something which arises out of the tax policy work programme scorecard, or incorporated in Budget 2012.	2 March 2012
Minister of Revenue	**Discuss** with officials at the joint tax policy meeting on 28 February 2012. **Agree** to recommendations. **Indicate** whether the estimated revenue should be treated as something which arises out of the tax policy work programme scorecard, or incorporated in Budget 2012.	2 March 2012

Contact for telephone discussion (if required)

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20 February 2012

Minister of Finance
Minister of Revenue

Mixed-use Assets

Executive Summary

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 on-going commitment to ensuring fairness across the tax system. The main category of mixed-use assets is holiday homes that are both rented out and used by their owners. Other assets, such as boats and aircraft, are also sometimes used in this way.

The officials' issues paper *Mixed-use Assets* was released in August 2011. The issues paper presented two alternative approaches of prescribing deductions for owners of mixed-use assets and sought submission on the suggested solutions. A total of 98 submissions were received. The majority of submitters recognised that the problem needs to be addressed; however, submitters had a number of concerns regarding the solution presented in the issues paper.

Following consideration of submissions, officials have developed a revised proposal that deals with many of the concerns raised by submitters (see diagram page 13). The revised proposal requires the majority of mixed-use asset owners to apportion their deductions based on the actual income-earning and private use of the asset. Two variations would apply for owners who derive small amounts of income from the asset. Firstly, owners whose gross income from the asset is below $1,000 in an income year would be able to opt out of the tax system altogether. Secondly, owners whose gross income from the asset in an income year was below 2% of the cost of the asset (or its rateable value, if land-based) would still be subject to the apportionment rules but any loss arising would be able to be carried forward and offset only against future profits from that asset. No minimum threshold would exist for GST purposes.

To ensure asset owners cannot sidestep the new rules by shifting their assets into different forms of legal ownership, we recommend applying the new rules to assets held by individuals, partnerships, trusts, and close, closely-held, qualifying and look-through companies (but not larger companies, where entity substitution is unlikely). Additional rules will be needed to deal with specific interest deduction and imputation issues that arise with companies.

Officials have discussed the concept of a framework where apportionment would be available to the majority of asset holders, with some limitations for those with low levels of income-

earning use, with a number of key submitters and other stakeholders. This framework was generally supported by those key submitters and other stakeholders. This dialogue has been useful and officials would like to continue it as detailed legislation is developed.

We would welcome the opportunity to discuss this issue with you at the joint tax policy meeting on 28 February 2012. If, following the meeting, you are comfortable with the proposed approach and agree that this matter can progress to legislation, we would prepare a draft Cabinet paper seeking inclusion of this proposal in the omnibus taxation bill likely to be scheduled for mid-2012.

Recommended action

We recommend that you:

(a) **Agree** that mixed-use assets should be defined as assets which are:

i. used for earning income and used privately by the owner and/or associated persons of the owner to one degree,
ii. not in use for at least 62 days in the income year,
iii. land and land improvements, and
iv. other assets with a cost of $50,000 or more.

but not:

i. assets to which the existing motor log book rules apply, or
ii. part of a family home used in earning income (for example, renting out a room to boarders or using a part of the home as a business office).

Agreed/Not Agreed Agreed/Not Agreed

(b) **Agree** that (subject to recommendations (c) and (d) below) the deduction claimed against the income derived from a mixed-use asset be apportioned based on actual income-earning use divided by the actual total use of the asset.

Agreed/Not Agreed Agreed/Not Agreed

(c) **Agree** that where the gross income derived from the asset in an income year is less than $1,000, asset owners should be able to treat the asset as being outside the tax base altogether, essentially for compliance cost reasons.

Agreed/Not Agreed Agreed/Not Agreed

(d) **Agree** that where the gross income from the asset in an income year is less than 2% of the cost of the asset (or its rateable value, if land-based) then the apportionment formula will still apply but if a loss results, that loss will be able to be carried forward and offset only against future profits from that asset.

Agreed/Not Agreed Agreed/Not Agreed

(e) **Agree** that the proposed rules should apply to assets held by individuals, partnerships, trusts (apart from widely held trusts, such as registered superannuation funds) and look-through companies, closely held and qualifying companies (where some additional rules will be required to deal with interest and imputation).

Agreed/Not Agreed Agreed/Not Agreed

(f) **Agree** that the recommended approach in (b), without the limitations set out in (c) and (d) also be used for calculating a registered person's GST input tax deductions.

Agreed/Not Agreed Agreed/Not Agreed

(g) **Agree** that officials continue to consult with key stakeholders as detailed legislative rules are developed.

Agreed/Not agreed Agreed/Not Agreed

(i) **Indicate** whether the positive revenue impact of an estimated $50 million per annum from the 2013/14 income year should be:

(i) Counted against the tax policy work programme scorecard (i.e. it would be used to fund future revenue-negative items on the work programme), as would be the usual practice; or
(ii) Used as a savings item in Budget 2012.

Scorecard / Budget 2012 Scorecard / Budget 2012

(h) **Note** that, once decisions have been made on the recommendations set out above a draft Cabinet Committee paper can be provided to you for submission to the Cabinet office by the end of March 2012, so that this issue can be considered by Cabinet before the Budget moratorium.

Noted

Noted

Phil Whittington
Analyst, Tax Strategy
Treasury

David Carrigan
Policy Manager
Inland Revenue

Hon Bill English
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Background

1. A mixed-use asset is an asset that is used for both private and income-earning purposes. Typical examples of assets used in this manner are holiday homes, and to a lesser extent, boats and light aircraft. As the return to owners from these assets is partly taxed (the rental income) and partly untaxed (private use by the owners and his or her family and other benefits of ownership), it is appropriate to limit the extent to which expenses and depreciation can be deducted to a level which accords with the income-earning use of the asset.

2. Existing income tax legislation states that a deduction is allowed for expenditure incurred in earning income and a deduction is denied for expenditure which is of a private or domestic nature. Existing GST legislation allows a deduction for input tax to the extent that the goods and services are used, or available for use, in making taxable supplies. Although these rules deliver the right policy outcome at a conceptual level, their generality means they can be difficult to apply to mixed-use assets. Two specific problems arise:

- How should expenditure which is incurred during time periods the asset is not being used at all be treated?
- How should expenditure which is general in nature (such as repairs and maintenance) be treated?

3. Currently, mixed-use asset owners can claim that their asset is available for income-earning use for the time when the asset is not in use. This provides them with a basis for claiming tax deductions for expenses relating to all of the periods the property is empty, and for an inflated proportion of the expenditure which is general in nature.

Holiday Home Example:
A simple example is a holiday home which 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 which directly relates to:

- the actual private use of the holiday home,
- expenditure which directly relates to the actual rental use of the holiday home,
- expenditure which relates to the 42 weeks of the year where the holiday home was not in use, and
- expenditure on one-off repairs and maintenance.

There is no concern about the owner claiming deductions for expenditure which relates solely to the five weeks per year the holiday home was rented. These deductions relate specifically to the actual income-earning use. It is equally clear that no deductions can be claimed for the five weeks per year when the holiday home was used by the owner. The issue is to what extent the owner should be able to claim deductions which relate to the 42 weeks of the year the holiday home was empty and the one-off repair and maintenance expenditure.

Currently, the owner can claim the holiday home is available for income-earning use for the time when the asset is not in use. As a result, the owner can make the argument that expenditure that arose in the 42 weeks the holiday home was empty is fully deductible expenditure, and the one-off repair and maintenance expenditure is 90% deductible – apportioned on the basis of 47/52. This could be regarded as an incorrect outcome considering that:

- the level of income-earning use and private use are equal,
- the asset was likely to also be available for private use during the unused times, or
- the main reason the person acquired and maintains the asset may have been for the owner's private enjoyment.

4. Although deductions calculated on this basis are broadly in accordance with legislative principles, and Inland Revenue has issued guidance material indicating that deductions can be claimed in this way, this level of deductions is disproportionate to the actual income-earning use of the asset. This is not a satisfactory policy outcome, and has three consequences:

- **Revenue impact** – the revenue collected from mixed-use assets is reduced due to the excessive deductions that can be claimed. Furthermore, the level of deductions will often exceed income earned from the asset, which means that no revenue is collected from the income-earning activity and the loss generated will be able to be offset against other income. The GST equivalent of this is that input claims exceed output tax returned, resulting in registered persons being in a net refund position;
- **Coherence** – the tax system ought to reflect the economic position of taxpayers as closely as possible, and a system which allows people to claim tax losses on a sustained basis is likely to be inconsistent with taxpayers' economic position as they are unlikely to be suffering sustained economic losses;
- **Perceptions of fairness** – the reputation of the tax system suffers if a perception arises that some taxpayers receive treatment which seems concessionary or "unfair". This reduces compliance generally.

Issues paper suggested approach

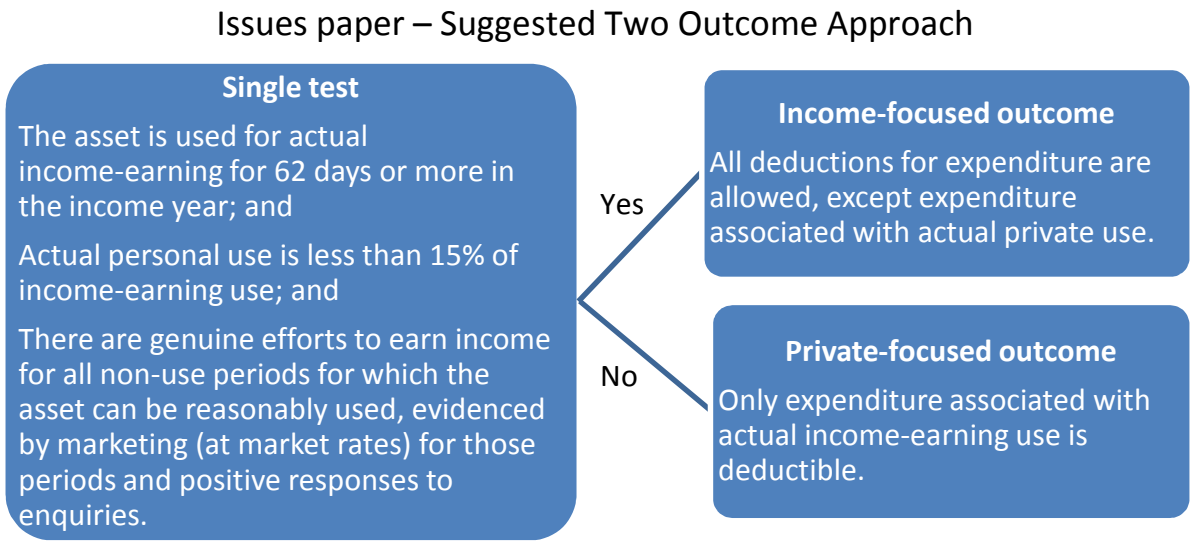
5. The revised approach proposed for mixed-use assets differs from the suggested approach set out in the issues paper released in August 2011. However, we have briefly set out the approach suggested in the issues paper below, to provide context for considering submissions.

6. The issues paper suggested legislating specific tests that categorise mixed-use asset owners into different groups based on the underlying use of the asset. Bright-line private use and income-earning use thresholds were suggested to distinguish between owners in different groups. The rules would then prescribe the level of deductions that owners in each group can claim. A range of outcomes would be possible, ranging from all expenditure being deductible

(other than purely private expenditure), to only expenditure that relates to actual income-earning use being deductible. Two approaches were suggested in the issues paper: a two-outcome approach and a three-outcome approach.

The two-outcome approach

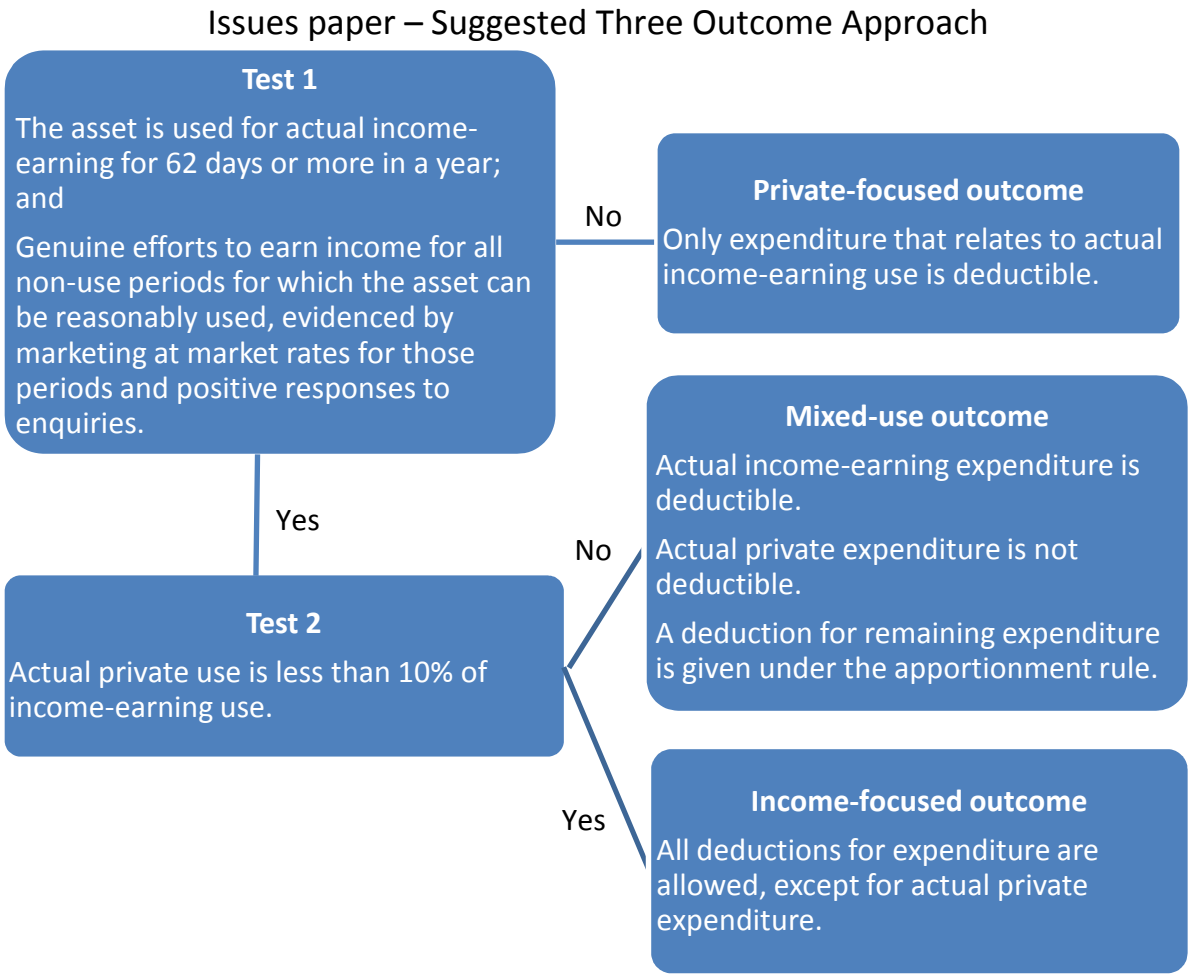
7. The two-outcome approach suggested a single test to identify whether an owner is income-focused. Owners classified as income-focused can claim all deductions, except for expenditure that is attributable to actual private use. If the owner did not meet the test, they would only be able to claim expenditure that is attributable to actual income-earning use (this is referred to as a private-focused outcome). This suggested test, which would apply in each income year, is described in the following diagram:



8. 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, and the second requires that personal use is less than 15% of income-earning use. The final element of the test is that the owner must have made genuine efforts to earn income for all non-use periods for which the asset can be reasonably used.

The three-outcome approach

9. The three-outcome approach is comprised of two tests. The first test identifies assets with a private-use focus, and the second test distinguishes between assets with an earning-income focus and those which are genuine mixed-use assets. The suggested two tests are as follows:



10. Test 1 contains two elements. The first is a bright-line element, setting a minimum level of income-earning use of 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, as evidenced by marketing and positive responses to enquiries. If the owner does not satisfy either element, the private-focused outcome will apply.

11. If the use of the asset passes Test 1, the owner is required to apply Test 2. Test 2 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% of income-earning use. If the use of the asset in the income year passes Test 2 (as well as Test 1), the asset will be subject to the income-focused outcome. If Test 2 is failed, the asset is treated as a genuine mixed-use asset and expenditure for non-use periods is apportioned.

12. The genuine mixed-use group can claim a proportion of expenditure that relates to the time the asset is not used. The proportion of expenditure is calculated using the apportionment formula, with the result produced being used to determine the level of both income tax and GST input tax deductions. The apportionment formula is as follows:

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

Holiday Home Example Two – Applying Apportionment Formula:
A holiday home owner uses the house for private purposes for 10 weeks a year and rents it for 10 weeks a year. Expenditure relating to the 32 weeks of the year that the holiday home is unused (unused time expenditure) is deductible at a rate of 50% calculated as 10 weeks income-earning use divided by 20 weeks of total use.

13. The issues paper suggested that rules should apply to assets that are:

- used both privately and to earn income,
- rented out on a short-term basis,
- not in use for at least two months in a year,
- land and other assets with a cost of $50,000 or more.

14. However, the suggested rules would not apply to assets:

- where the existing motor log book rules apply, or
- which are part of a family home used for earning income (for example, renting out a room to boarders or using a part of the home as a business office).

Submissions

15. A total of 98 submissions were received. A detailed analysis of those submissions is set out in the Appendix, and the key points are summarised below. The majority of submitters (67%) recognised that there is a problem that needs to be addressed. A small number of submitters (around 3%) did not think that any new rules were required, and the rest of submitters did not indicate either way. Only four submitters commented directly on the GST proposals.

16. The majority of submissions received were from individual holiday home owners (around 80% of submissions received). The rest were from dedicated businesses that advertise and/or manage the income-earning element of mixed-use assets for their owners (holiday home advertising websites and charter boat firms), accounting firms, and a law firm.

17. Around 60% of the submissions received were standard form letters that holidayhouses.co.nz sent out to their members informing them of the suggested rules, and encouraging them to send in the standard form letter with additional comments relating to their specific circumstances.

18. Submitters raised a number of concerns with the approaches suggested in the issues paper. By a significant margin, the three most submitted concerns were regarding:

- **The income-earning threshold:** Around 85% of submitters argued that 62 days of income-earning use threshold was not obtainable for many mixed-use assets, even if the owner had a genuine income-earning focus.
- **Private use threshold:** Around 70% of submitters thought that the suggested private use threshold of 10% or 15% of income-earning use was too low. Submitters who owned holiday homes argued that often the main reason for using their holiday house was either to carry out repairs and maintenance or to prepare the house for incoming tenants. Submitters strongly believed this type of use should not be classified as private use.
- **Repairs and maintenance:** Similar to the above concern, many submitters (around 70%) stated that, typically, a large portion of a mixed-use asset use is conducting repairs and maintenance. Submitters were concerned that no allowance was made in the issues paper for use of this type, and that it should not be regarded as private use of the asset.

Compliance costs

19. The issues paper specifically asked whether the suggested changes would create unwarranted compliance costs and to what degree. Around 10% of submitters responded on this issue. A range of responses was given. Around half of the submitters that commented on this issue thought that officials should not be discouraged by complexity if more complex rules would give fair and accurate results. The other half thought that the suggested rules were too complex and that, if the suggested rules were implemented, owners would attempt to avoid them through non-compliance or would stop renting out their assets.

Preferred approach

20. The issues paper specifically requested that submitters indicate whether the two-outcome or the three-outcome approach was preferred. All of the submitters that indicated a preference (only around 10%) preferred the three-outcome approach. The reasons given for the preference were that the three-outcome approach delivered fairer outcomes and related more directly to real world situations. Submitters particularly liked the apportionment outcome included in the three-outcome approach. In contrast, the submitters found the two-outcome approach too arbitrary and thought that it would result in unfair outcomes.

Revised Proposal

21. A revised proposal has been developed in response to the submissions received from the issues paper. Many submitters thought that an apportionment of expenses based on the underlying use of the asset was a more appropriate solution to the problem. From a policy perspective apportionment, is generally a reasonable outcome, as the actual use of the asset is the best available objective measure of the economic use of the asset on which deductions can be based. Although apportionment does not recognise the other benefits that mixed use asset owners get from their assets – such as availability for use – these benefits are very difficult to quantify.

22. Consequently, the revised proposal allows the majority of owners to apportion their deductions.

23. However, there are some issues with allowing mixed-use asset owners with low levels of income-earning use to claim deductions under the apportionment method. This is because:

- Under an apportionment method owners with low levels of income-earning use have a strong incentive to modify behaviour or distort use in order to achieve higher levels of deductions. This is because a forgone or additional night of private or income-earning use will produce significant tax effects when days of actual private use and income-earning use are low.
- Owners who rent their assets for a small number of nights may hold the asset primarily for private enjoyment, and arguably should not be entitled to any tax deductions for periods of non-use.
- Asset owners who have low levels of income-earning use face compliance costs in meeting their tax obligations which are disproportionate to their income.

24. It is expected that some taxpayers who receive income from very few nights of rental do not currently return that income for tax purposes, because of the compliance cost and low chance of being audited.

25. The revised proposal modifies the standard apportionment rule in two separate ways for taxpayers with low levels of income from their mixed use asset. Those who have gross income from the asset which is less than 2% of:

- the cost of the asset, or
- the rateable value of land and improvements, where the asset is land-based

will remain subject to the apportionment rules. However, if a loss arises, it cannot be offset against other income, but must be carried forward to be offset against any future profits from that asset ("loss ring-fencing").

26. Loss ring-fencing is designed to deal with the first two points described in paragraph 23. The first is that owners who have low levels of income earning use where a few days can have dramatic effects are likely to be in loss. They will be less likely to be disproportionately influenced in their behaviour by tax outcomes where that tax outcome is a loss which, if income earning use remains low, will never be able to be used.

27. The second is that low levels of income earning use are often associated with assets held primarily for private enjoyment. Where low levels of income continue from year to year, loss ring-fencing effectively ensures that these owners never get to claim a tax loss, which is the same effect as excluding them from the tax base altogether – probably the right policy outcome for this class of asset owner. However, an asset owner who has a single year of low income, perhaps because of a natural disaster, will be able to offset the loss that arises in that year against their future profits.

28. Loss ring-fencing has previously been considered, but rejected, as a mechanism to deal with issues in other parts of the tax system. It is an appropriate mechanism to use here, for the following reasons:

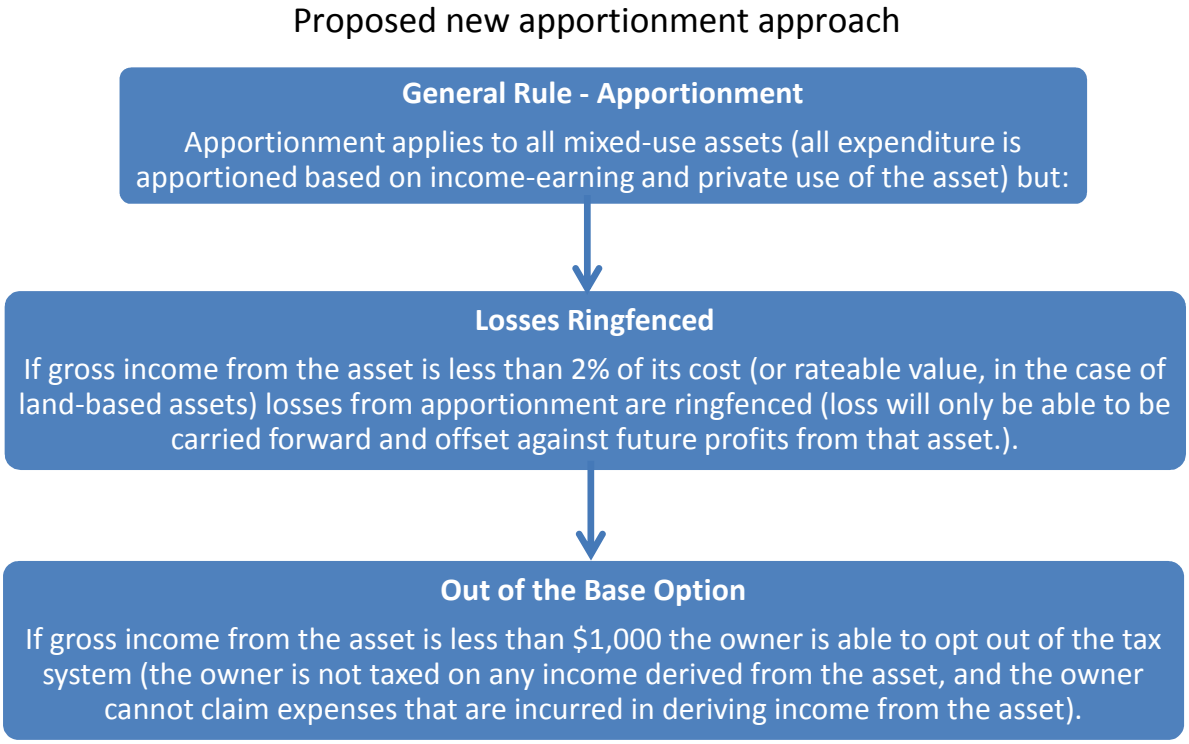
- At issue are situations where there is a mismatch between the total return derived by the taxpayer and the basis on which deductions were calculated. The mismatch can occur in two general situations. First, an activity is entirely within the commercial sphere, but some part of the income is not taxed or is taxed on a deferred basis. Second, the activity is in the personal, non-commercial sphere, so costs should not in principle be deducted against income earned on other taxable activities.
- Loss ring-fencing in the first instance does not address the fundamental problem and gives rise to a number of biases and inefficiencies. These do not arise where the objectives of the activity are both income earning and to deliver private benefit to the owner.
- In the second case, deduction denial directly addresses the fundamental problem. The logic is very similar to one of disallowing deductions for expenditure on consumption goods such as ice-creams. Deductions should not be allowed for expenditure aimed at providing consumption benefits.
- Problems of application arise when an activity can have a mixed commercial and personal use. The problem then is to allocate costs between the two spheres. This mismatch has been addressed by the apportionment formula, which seeks to align the basis of deductions with the taxable income.
- However, situations can arise where a loss results despite the limitation of deductions. In one case, the loss can be considered to arise from a commercial activity, and should arguably be deductible. In the second, the loss may arise because the activity, taken as a whole, is inherently non-commercial. It is impractical to define this borderline.
- Loss ring-fencing effectively differentiates between the two situations in a practical manner. The first situation is where the asset will be profitable over the longer term, but is loss-making in a particular year, perhaps as a result of seasonal fluctuation or its customer base being developed over time. Here, the loss should be allowed against future income arising from the asset. The second situation is where the asset will not be profitable over the long term, and notwithstanding apportionment, a loss has arisen. This is evidence that the activity is non-commercial overall. Here, loss ring-fencing essentially means that the activity and its associated deductions remain outside the tax base.

29. The second variation to the standard apportionment rule is for those mixed-use asset owners whose gross income from the asset is less than $1,000. Those asset owners can choose to have their income earning use of their mixed-use asset outside the tax system – which means that income is not subject to tax, but no deductions can be claimed. This variation is designed to address compliance cost and deadweight loss concerns – requiring asset owners to maintain records, file returns, and to have Inland Revenue process them is not considered to be justifiable for a maximum of a few hundred dollars of revenue.

30. Allowing taxpayers to choose whether to be inside the tax system or not would normally be avoided because those who would otherwise have a tax liability will opt out, whereas those who can claim a loss will opt in. Here, because of loss ring-fencing, some loss-making owners may also choose to opt out – if the loss which arises will never actually be able to be used, there is no point incurring the compliance costs to record it. Some asset owners may use it as a legitimate mechanism to not pay tax on income that would otherwise

be taxable – but these amounts will be very small, as it is likely that some expenses will be deductible from the gross revenue of $1,000.

31. The structure of the revised proposal is as follows:



32. This approach alleviates some of the concerns with the original suggested approach in the issues paper. Owners would no longer be required to meet the 62 day income-earning threshold or remain under certain levels of private use in order to gain higher deductions. Further, concerns regarding time spent conducting repairs and maintenance is less of an issue given that the private use threshold has been withdrawn.

33. Broadly the same approach is proposed for calculating GST input tax deduction. The one exception is that no minimum threshold should apply for GST. As GST-registered asset owners are required to charge output tax on their supplies, denying them all input tax deductions if they do not reach a set threshold would be inconsistent with the approach applied to voluntary registration for other industries and activities. Instead, what is proposed for GST is to require full apportionment of input tax, in line with the general GST apportionment rules introduced in 2011.

Application of proposed rules

34. Paragraphs 13 and 14 above set out the elements which make up the definition of the assets which the new rules would apply to. Submitters generally agreed that this definition was appropriate and with one exception, discussed below, we do not propose any changes to that definition.

35. One element of the definition was that the asset was rented out on a short-term basis. This was designed to capture the majority of assets we are concerned about – primarily

holiday homes, but also boats and aircraft which are rented out and used privately. However, this gives rise to a consistency issue where similar assets are used in a business (instead of rented out) and also used privately.

Helicopter Example:
A helicopter owned by a farmer can be used by the farmer for farming purposes (used to derive income) and used by the farmer for his/her personal enjoyment. This asset is never rented out. However, the farmer faces the same uncertainty as to what proportion of expenditure that arises when the helicopter is not used is an allowable deduction. This uncertainty is likely to be resolved by the farmer claiming all expenses except those which directly relate to private use of the helicopter (or for general expenses, a proportionate approach which excludes only actual private use).

36. This consistency issue is most likely to arise with aircraft and boats (such as those used in fishing charters). However, rather than broadening the test just for these specific asset types, we recommend the test be broadened generally, for simplicity and greater consistency.

37. The proposed rules, therefore, should apply to assets that are used in a business or as part of a process of deriving income, not just rented out, in addition to the other requirements set out in paragraphs 13 and 14.

Detail of revised proposal

38. The main other detailed aspects of the proposal are as follows:

- It is proposed that the apportionment formula apply to the majority of expenditure that is incurred throughout the year, as opposed to only expenditure that was incurred in times of non-use, as suggested in the issues paper. This measure simplifies compliance for asset owners. It also eliminates the risk inherent in a self-categorisation approach, which is that some owners might seek to argue that expenditure on maintenance or depreciable improvements and chattels relate purely to the income earning use of the asset and should not be apportioned.
- A limited exception to the above rule is that some purely income-earning related expenditure (such as advertising expenditure) should be fully deductible and not subject to apportionment. This type of expenditure does not provide any private benefit and is only incurred in deriving income; consequently this expenditure should be fully deductible. Equally, purely private expenditure that does not contribute to income-earning will not be deductible. These exceptions are expected to be narrow and limited in scope.
- The issues paper sought views on whether use of a mixed-use asset by associated persons should be regarded as private use regardless of whether market rent is paid. The issues paper suggested that use of this nature should be regarded as private use in order to prevent owners from inflating the income-earning use of the asset by paying market rent and thus receiving higher levels of deductions. Following consideration of submissions, we think that this exclusion should be narrowed from the standard test of two degrees of blood relationship to one degree of blood relationship. This approach was generally supported by the key stakeholders we spoke to.

- Time spent conducting repairs and maintenance by the owner should be regarded as private use. Although some asset owners may object to this, any alternative would appear to allow owners to treat some or all private use as time spent conducting repairs and maintenance. This would distort the apportionment calculation and allow excessive levels of deduction to be claimed – so defeating the policy intent of these proposals. Officials expect this aspect of the rules to be unpopular amongst mixed-use asset owners. Around 70% of submitters on the suggested rules in the issues paper had concerns regarding the treatment of repairs and maintenance. However, these concerns should be less of an issue as there is no longer a private use threshold.
- To ensure consistent treatment across different forms of legal ownership, it is recommended that the rules apply to assets held by individuals, partnerships, trusts (apart from widely held trusts, such as registered superannuation funds) and look-through, close, closely held and qualifying companies. Special rules will be needed to deal with interest deductibility and imputation credit issues in companies.
- From a GST perspective, rules will need to accommodate the fact that GST is not generally an annual tax. Mixed-use asset owners are likely to file GST returns on a two- or six-monthly basis, so provision will need to be included for a wash-up calculation to take place each year to ensure that input tax deductions reflect the position arrived at for income tax purposes.

39. A number of minor technical issues were raised during consultation, which officials are working through. Officials consider that these issues can be resolved consistently with the broad proposal outlined above and, therefore, will not require Cabinet approval. We will report to you on these later.

Further consultation

40. After the development of the revised proposal the key submitters/stakeholders were consulted regarding the updated mixed-use asset proposal in December 2011 and January 2012. Key submitters/stakeholders included:

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41. The submitters/stakeholders we consulted with generally supported the revised framework.

Fiscal Implications

42. On the basis of the policy settings above, our estimate of the fiscal implications of these proposals on residential property is a revenue increase of approximately $50 million per annum. A number of important assumptions have been used in estimating this figure, including the number of holiday houses rented, the level of deductions being claimed now, and the level of deductions available in the future. Other mixed-use assets such as boats and aircraft have not been included in the costings due to insufficient source data.

43. One decision for Ministers is whether to count the positive revenue impact of this policy ($50 million per annum from the 2013/14 income year) against the tax policy work programme scorecard, as would be the usual practice. The scorecard is the mechanism for managing the revenue impacts of items from the tax policy work programme. The scorecard allows flexibility in the tax policy space, as revenue gains are retained in order to offset revenue costs arising from other tax policy changes. This allows the tax policy work programme to be managed in a more coherent manner. However, recognising fiscal imperatives, Ministers may, in this instance instead wish to use this revenue as a savings item in Budget 2012. This would require more careful management and sequencing of upcoming tax policy work programme items.

Compliance Costs

44. One of the objectives of the revised proposal was to reduce the compliance costs inherent in the proposals set out in the issues paper. Minimising compliance costs is an important aspect of these proposals and is the basis for allowing those with less than $1,000 of gross income to "opt out" of the tax system. Minimising compliance costs is the reason that subjective tests such as "intention" were rejected in favour of simple objective tests based on use. Owners of mixed-use assets are very likely to already be recording both private and income-earning use to meet their obligations under current law. Accordingly, we do not expect these proposals to give rise to a significant increase in compliance costs once the new rules are understood.

Administrative Implications

45. Any administrative costs associated with these proposals are small and will be met from existing baselines.

Appendix

Summary of Submissions on August 2011 Mixed-use Assets Issues Paper

Overview

1. A total of 98 submissions were received on the *Mixed-use Assets* issues paper. Overall, the majority of submitters, around 67%, recognised that the issue needs to be addressed. A small number of submitters, around 3%, did not think that any new rules are required (one submitter suggested a more comprehensive interpretation statement may achieve the desired outcome), and the rest of submitters did not indicate either way.

2. Many of the submitters made very similar points concerning the details of the suggested rules. The submission points can be summarised into eight main headings:

- The two-outcome vs. three-outcome approach,
- The 62-day income-earning threshold,
- The private use threshold,
- Repairs and maintenance,
- Compliance costs,
- Application of the suggested rules,
- Market rent paid by associates, and
- Entities the rules should apply to.

3. Around ten submitters offered alternative approaches that could be used, or modifications to the suggested rules. A number of other points were also made and are summarised at the end of this appendix.

The submitters

4. The majority of submitters (around 80%) were individual owners of holiday homes. The other 20% of submitters were a mix of:

- individuals, companies and trusts owning boats,
- dedicated businesses that advertise and/or manage the income-earning element of mixed-use assets for their owners,
- accounting firms, and
- a law firm.

5. Some of the large entities that made a submission were:

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6. Around 60% of the submissions received were standard form letters that Trade Me (owners of holidayhouses.co.nz) sent out to their members informing them of the suggested rules, and encouraging them to send in the standard form letter with additional comments relating to their specific circumstances.

Standard form letters

7. All the standard form letters indicated that the existing issue of the deductibility of unused time needs to be addressed, but that the suggested 62-day income-earning threshold would be too difficult to achieve, the personal use restriction is too restrictive, and the suggested rules would not allow for owners carrying out normal and reasonable maintenance.

8. The standard form letter also encouraged submitters to describe their personal circumstances. In general, submitters indicated that, due to their personal circumstances, it is unlikely they would be able to achieve the 62-day income earning threshold, particularly if:

- their holiday home is situated in a remote location,
- there is a poor season in a year (ski season or summer season), or
- there is another recession, which dramatically reduces the demand for these assets.

9. Many standard form submitters also indicated that, when they use their holiday home for themselves, they are often conducting repairs and maintenance or preparing the house for incoming tenants. The submitters stressed that this type of use should not be regarded as private use.

Main submission points

Two-outcome or three-outcome approach

10. The issues paper specifically requested that submitters indicate whether they preferred the two-outcome or three-outcome approach. All the submitters who expressed a view on this issue (around 10% of submitters) preferred the three-outcome approach. Generally, this was because the three-outcome approach was viewed as delivering fairer outcomes and relating more directly to real-world situations. Submitters found the two-outcome approach too arbitrary and liable to deliver unfair outcomes.

The 62-day income-earning threshold

11. The vast majority of submitters (around 85%) made submissions concerning the 62-day income-earning threshold. The primary concern was whether the 62-day threshold was an appropriate approximation of the income-earning potential of the different types of mixed-use assets. A number of reasons were given, including:

- Yachts, planes and holiday homes have different income-earning potentials, and therefore a single income-earning threshold is inappropriate.

- Seasonal mixed-use assets have less income-earning potential than assets that can be rented all year round. For instance, a ski chalet can generally only be rented during the ski season, whereas a city apartment can be rented throughout the entire year.
- Holiday homes situated in popular locations have a greater income-earning potential than holiday homes situated in less popular locations.
- Holiday homes located near busy centres have a greater income-earning potential than holiday homes located in remote areas.
- High value mixed-use assets are often used less than low value assets; however, high value assets can still achieve high levels of income.

12. Overall, the primary concern was that 62 days of income-earning use was unobtainable, even if the owner had a genuine income-earning focus.

13. Many submitters noted the impact of the recession, which they claim has significantly reduced demand for certain types of assets. Other factors that submitters mentioned may impact their ability to achieve the income-earning threshold were:

- As many mixed-use assets are seasonal, a poor season could prevent the asset from achieving its income-earning potential.
- Unforeseen circumstances may prevent the asset from being used for income earning, for example, the owner may fall ill.
- Assets are often taken off the market in order to conduct repairs and maintenance.

14. Submitters suggested lower income-earning thresholds, averaging around 30 to 50 days.

The private use threshold

15. The issues paper suggested that an asset owner would be able to claim deductions beyond those directly attributable to income-earning days only if private use was less than 10 or 15% of income-earning use. A high number of submitters (around 70%) thought that the suggested private use threshold was set too low. Submitters who owned holiday homes argued that, often, the main reason for using their holiday home was either to carry out repairs and maintenance or prepare the house for incoming tenants. Submitters strongly believed that this type of use should not be classified as private use.

16. Two further points were made:

- The private use rule would be totally reliant on an owner's honesty in declaring their private use, as there is little evidence to prove or disprove an owner's declaration.
- Owners may falsely declare low private use in order to receive higher deductions.
- The private use rule may result in owners renting assets instead of using their own, to avoid exceeding the private use threshold.

17. Submitters suggested higher private use thresholds, averaging around 15 to 21 days, and that use of the asset for the purpose of repairs and maintenance should not be included in the private use threshold.

Repairs and maintenance

18. As stated above, many submitters (around 70%) thought that days conducting repairs and maintenance should not count towards the owner's private use of the asset. Instead,

submitters suggested that days spent conducting repairs and maintenance should go towards non-use days. Alternatively, submitters suggested that a separate allowance should be made for repairs and maintenance, for example one day for every 14 days of paid rental should be allowed.

Compliance costs

19. A small number of submissions (around 10%) considered the compliance costs that the suggested rules may place on mixed-use asset owners. A range of responses were given, summarised below:

- The suggested rules are very simple and officials should not be discouraged by complexity if more complex rules would give fair and accurate results.
- The suggested rules are too complex and if the suggested rules are implemented, owners will attempt to avoid them through non-compliance or will simply stop renting out their assets.
- The compliance cost burden brought about by the suggested rule would depend on the owner. Owners who use businesses to advertise and manage their assets may face lower compliance costs than individuals.

20. One submitter made the point that an owner's use of a mixed-use asset may change from year to year and, consequently, under the suggested rules the owner will be required to apply different rules in different years. The submitter argued this would be an additional compliance cost on some owners.

Application of the suggested rules

21. All of the submitters who made a submission on the application of the new rules (four submitters) agreed that a conceptual approach should be taken when determining the assets any new rules will apply to, rather than a list of assets.

22. Three out of the four submitters agreed that any new rules should not apply to motor vehicles and owner-occupied housing, as the current rules are sufficient. The submitter who disagreed also thought that the amount of deductions available to lifestyle block owners should be restricted, and that the rules should not be restricted to assets that are rented out on a short-term basis. One submitter also suggested that aircraft should not be subject to any new rules.

23. Four submissions were made on the $50,000 de minimis threshold. Two submissions agreed that the de minimis was set at the correct level. One submission suggested that the de minimis could be raised to $250,000 without significant revenue loss, and the other thought the de minimis was set too high. It was also suggested that instead of using the asset's cost, taxpayers could elect to use the asset's market value.

Market rent paid by associates

24. Submitters who submitted on this issue (around 10% of all submitters) thought that the suggestion of treating use by an associated person (defined using the existing test) as private use was too wide. Apart from one submission, there was consensus that if market rent is paid by a second degree or greater associate, the use should be considered as income-earning use.

25. One submitter suggested that deductions could be limited to the amount of income received by associated persons.

Entities the rules should apply to

26. Two submitters suggested the application of the rules on companies should be carefully looked at to ensure equitable outcomes are achieved. There was particular concern that companies may be over-taxed if the suggested rules go ahead.

27. One submitter suggested that a rule should be created to prevent partnerships from splitting the value of the asset to avoid the de minimis threshold.

Alternative approaches

28. A number of submissions contained a range of alternative approaches, or simply modifications, to the models suggested in the issues paper. The suggestions are summarised below:

- A safe harbour for owners who only achieve minimal income-earning use, in which case the owner will not have to declare any income and cannot claim any deductions. Submitters have suggested safe harbour thresholds ranging from 15 to 30 days of income-earning use.
- A rental income threshold could be used instead of, or as an alternative to, the income-earning day threshold. Two submitters thought that if rental income exceeded $60,000 then the owner should be able to claim all of the expenditure incurred during non-use days. Other submitters suggested that if rental income is below $7,500 (some suggested $15,000), the owner should not be able to claim any expenditure incurred during non-use days.
- The common law "business test" should be applied to any new mixed-use asset rules. If an owner's income-earning activities equate to a "business", then the owner should be able to claim all the expenditure incurred during non-use days.
- An approach similar to the approach used in France should be considered. For example, the level of deductions and profit is prescribed based on rental income.
- The income-earning day threshold should be dependent on whether the asset is located within 250km of a city centre. There would be a higher income-earning threshold for assets located within 250km of a city centre, and a lower income-earning threshold for assets located further than 250km from a city centre.
- Compliance costs could be reduced by apportioning all expenses throughout the year, not just over unused time.
- The apportionment formula could be used by all mixed-use asset owners instead restricting it to some asset owners, with others having different outcomes.
- Any assets which are subject to full-time commitments under management or charter agreements should be exempt from the rules, with full deductions being available.

Other points made

- All submitters agreed that advertising on a website should be sufficient to satisfy the condition of marketing.
- One submitter asked for clarification as to whether "a night for free if the tenant pays for a certain number of nights" would be classified as income-earning use.
- Two submitters made the point that the units used to calculate income earning and private use are incorrect. The accommodation industry uses nights, but the aircraft and boating industries use hours.

- One submitter had concerns about how the suggested rules would apply to pooled assets, for example a managed block of apartments.