

# **The Treasury**

## **Budget 2012 Information Release**

### **Release Document**

#### **June 2012**

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Cabinet Economic Growth and Infrastructure Committee

## **Proposed Mixed-use Assets Rules**

### **Proposal**

1. This paper seeks Cabinet's agreement to include changes to the Income Tax Act 2007 and Goods and Services tax Act 1985 in the July 2012 omnibus taxation bill, which limit the amount of deductions available to mixed-use asset owners.

2. A review of the deductions available for mixed-use assets, and the release of an officials' issues paper, were announced as part of Budget 2011. As part of Cabinet's approval process, Cabinet requested that the consultative paper be referred to the Cabinet Economic Growth and Infrastructure Committee for its consideration (CAB (11) 17/4 refers). Cabinet agreed to release the officials' issues paper *Mixed-use Assets* in August 2011 (CAB (11) 30/9 refers). The paper suggested approaches of prescribing deductions for owners of mixed-use assets and sought submissions on the suggested solutions. The proposal in this paper has been developed in response to the submissions received and following direct consultation with key stakeholders.

### **Executive summary**

3. 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. Most mixed-use assets are 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.

4. 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.

5. Following consideration of submissions, officials have developed a revised proposal that deals with many of the concerns raised by submitters. 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:

- 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 (the owner is not taxed on

any income derived from the asset, and the owner cannot claim expenses that are incurred in deriving income from the asset).

- Owners whose gross income from the asset in an income year is 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 could only be carried forward and offset against future profits from that asset (loss ring-fencing).

6. It is recommended that the apportionment rules should also apply to GST input tax; however, neither of the limitations above should apply for GST purposes.

7. To ensure that asset owners cannot sidestep the new rules by shifting their assets into different forms of legal ownership, it is recommended 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.

8. In order to target the assets that are of most concern, it is recommended that the rules apply to assets which are:

- i. used for earning income and used privately by the owner and/or associated persons of the owner to one degree (for example, partner, siblings, children and parents of the owner),
- 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).

9. Officials have discussed, with a number of key submitters and other stakeholders, the concept of a framework where apportionment is available to the majority of asset holders, with some limitations for those with low levels of income-earning use. This framework was generally supported by key submitters and other stakeholders.

## **Background**

10. 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.

11. Existing income tax legislation states that a deduction is allowed for expenditure incurred in earning income, and 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 in use be treated?
- How should expenditure which is general in nature (such as repairs and maintenance) be treated?

12. 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 that the asset is not in use, and for an inflated proportion of the expenditure which is general in nature.

**Holiday home 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:

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

Currently, the owner can claim that 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 argue that the expenditure that arose in the 42 weeks the holiday home was empty is fully deductible expenditure, and the one-off repairs and maintenance expenditure is 90% deductible – apportioned on the basis of 47/52. This could be regarded as an incorrect outcome, considering that:

- the levels 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 their private enjoyment.

13. 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. Further, 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 can 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 a taxpayer's 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.

## Comment

14. The proposal outlined in this paper has been developed in response to the submissions received from the officials' issues paper *Mixed-use Assets*, released in August 2011. Many submitters thought that an apportionment of expenses based on the underlying use of the asset would be a fair and 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.

15. Consequently, the proposal requires the majority of owners to apportion their deductions. The proportion of expenditure is calculated using the apportionment formula, and the result is used to determine the levels of both income tax and GST input tax deductions. The apportionment formula is as follows:

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

**Actual private use:** Use of the asset by the owner, associated persons of the owner to the first degree (for example, partner, siblings, children and parents of the owner), and non-associated persons for less than the market rate.

**Actual income-earning use:** Use of the asset by non-associated persons in return for the market rate.

**Expenditure:** All expenditure incurred, excluding purely income-earning expenditure (for example, advertising costs), and purely private expenditure.

16. The following example demonstrates the income tax operation of the apportionment formula:

**Holiday home example – 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. Applying the apportionment formula, expenditure incurred in using the holiday home is deductible at a rate of 50%, calculated as 10 weeks of income-earning use divided by 20 weeks of total use.

*Loss ring-fencing*

17. Officials are concerned that some owners with low levels of income from their asset may still be able to claim losses, despite applying the apportionment formula. Some of these owners are likely to hold the asset primarily for private enjoyment, and therefore should not be entitled to claim losses. Other owners may genuinely hold the asset for mixed-use purposes, but be in loss in one particular year due to circumstances outside their control, for example a poor rental season. These owners should be entitled to those losses. To address this concern, owners who have gross income from the asset which is less than 2% of the cost of the asset (rateable value if 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”). The application of loss ring-fencing is demonstrated in the following example:

**Holiday home example – loss ring-fencing:**

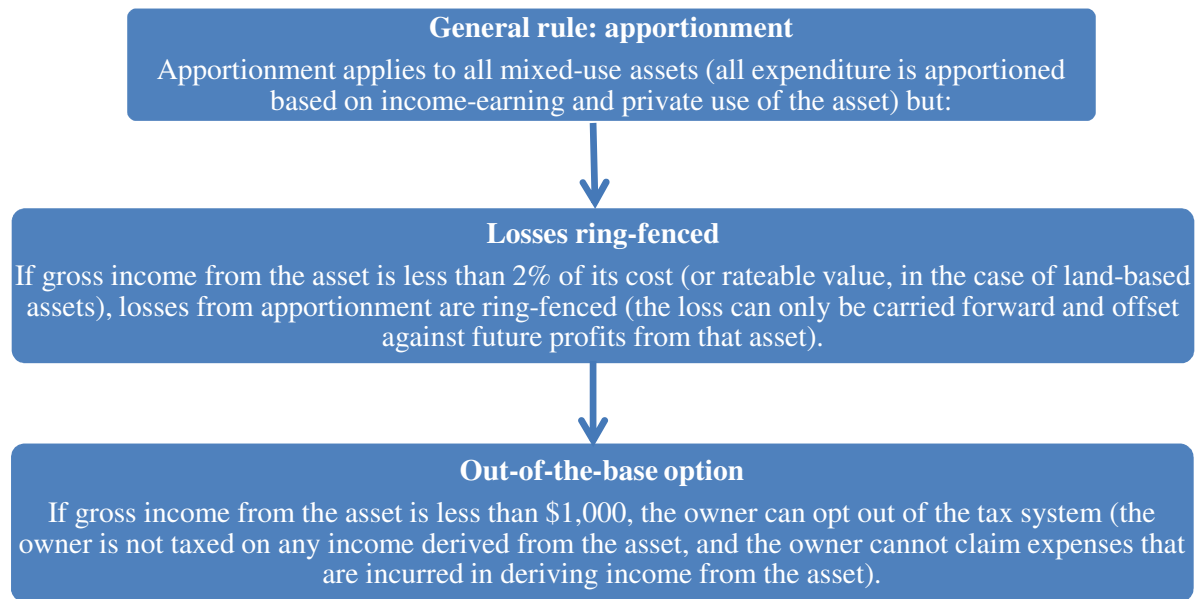
A holiday home has a rateable value of \$300,000. The holiday home owner rents out the holiday home and receives gross revenue of \$5,000. After applying the apportionment formula, the owner has allowable deductions of \$10,000. Therefore, after deducting allowable expenditure from the income received, the owner is in a \$5,000 loss position. Since the gross revenue received from renting out the holiday home is less than 2% of its rateable value ( $2\% \text{ of } \$300,000 = \$6,000$ ), the owner cannot use the \$5,000 loss to offset against other income. Instead, the owner carries forward the loss to off-set against future profits from the holiday home.

*Opt-out threshold*

18. Another variation to the standard apportionment rule is for mixed-use asset owners whose income from the asset is less than \$1,000. These asset owners can choose to have their income-earning use of their mixed-use asset outside the tax system, which means that the 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 having Inland Revenue process the returns is not considered cost-effective for a maximum of a few hundred dollars of revenue.

### *Structure of proposal*

19. The structure of the proposal is summarised in the diagram below:



20. It is recommended that the “general rule” apply for calculating all GST input tax deductions. Applying a minimum threshold for GST would cause difficulties because this would effectively require taxpayers to guess, at the start of the year, whether or not they will exceed the threshold. Further, ring-fencing GST “losses” is not feasible because the GST system provides cash refunds when input tax deductions exceed output tax charged.

### *Scope of the proposal*

21. To ensure that asset owners cannot sidestep the new rules by shifting their assets into different forms of legal ownership, it is recommended 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.

22. In order to target the assets that are of most concern, it is recommended that the rule apply to 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).

## Consultation

23. An officials' issues paper, *Mixed-use Assets*, was released for consultation in August 2011. The issues paper suggested categorising mixed-use asset owners into different groups based on the underlying use of the asset. Thresholds based on days of private use and income-earning use categorise owners into 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 (other than purely private expenditure) being deductible, to only expenditure that relates to actual income-earning use being deductible. A total of 98 submissions were received in response to the suggested categorisation approach.

24. Although the majority of submitters recognised that the problem needs to be addressed, submitters raised a number of concerns with the suggested proposal in the issues paper. Most concerns focused on the income-earning and private use thresholds. Submitters argued that the thresholds were too difficult to meet and were not aligned with commercial reality. Submitters were concerned that time spent conducting repairs and maintenance would be classified as private use and, therefore, would push many owners over the private use threshold.

25. It was not clear from the submissions whether the rules suggested in the issues paper would impose a significant compliance burden on owners, who are required to calculate their liability accurately anyway, under existing law. It is likely that the proposals may initially impose compliance costs on individuals and business; however, these compliance costs are likely to reduce with time as the new rules are better understood.

26. As stated previously, the proposal outlined in this paper was developed in response to the submissions received from the issues paper. This proposal is simpler than the approach suggested in the issues paper, as it eliminates the need for owners to achieve certain levels of income-earning use or remain under certain levels of private use in order to gain higher deductions. Concerns regarding the time spent conducting repairs and maintenance are also less of an issue as there is no longer a private use threshold.

27. In December 2011 and January 2012, key submitters/stakeholders were directly consulted regarding a revised proposal where apportionment was available to the majority of asset holders, with some limitations for those with low levels of income-earning use. Key submitters/stakeholders included accounting and law firms, charter boat firms, holiday home rental firms, and aviation sector bodies. All of the submitters/stakeholders consulted generally supported this proposal.

28. Inland Revenue has worked closely with the Treasury, which agrees with the analysis and recommended option.

29. On 5 March 2012 the Officials Economic Growth and Infrastructure Committee (OEGI) considered this Cabinet paper and the attached Regulatory Impact Statement. OEGI had no comments.



## Financial implications

30. The fiscal implication of this proposal 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.

31. The fiscal impact of this change is expected to be as follows:

\$m increase/(decrease)				
	2012/13	2013/14	2014/15	2015/16 & outyears
Tax Revenue: mixed use assets	0.000	9.000	50.000	50.000

## Human rights

32. There are no inconsistencies between the proposals in this paper and the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993.

## Legislative implications

33. The proposal requires legislative changes to the Income Tax Act 2007 and the Goods and Services Tax Act 1985. It is recommended that the proposal should be included in the omnibus tax bill proposed to be introduced around July 2012.

34. The recommended application date for the new rules is the start of the 2013/14 income tax year.

## Regulatory impact analysis

35. The Regulatory Impact Analysis requirements apply to the proposal. A Regulatory Impact Statement (RIS) is attached.

36. The Work Programme Manager, Policy Advice Division, has reviewed the *Mixed-use Asset* RIS and considers that the information and analysis summarised in it meets the quality assurance criteria of the Regulatory Impact Analysis framework.

37. The RIS provides an analysis of options to address the current uncertainty regarding the amount of deductions that mixed-use assets owners can claim. The problem is well-defined and the status quo clearly articulated, reflecting the disproportionate amount of tax deductions that owners of mixed-use assets can currently claim and how this would continue. The objectives which follow relate logically to and fully cover the problem definition.

38. The RIS identifies two options to apportion the amount of tax deductions that owners of mixed-use assets can claim; both options have been fully developed. No social, cultural or

environmental impacts are anticipated. The recommended proposal may moderately reduce investment in mixed-use assets, as the level of tax deductions available to owners will be reduced.

39. There is clear evidence of efficient and effective consultation with all relevant stakeholders, key affected parties and Government agencies. Many of the issues raised during consultation have been addressed.

40. The included agency disclosure statement identifies no significant constraints, caveats or uncertainties concerning the regulatory analysis.

41. We have considered the analysis and advice of officials, as summarised in the attached RIS, and are satisfied that, aside from the risks, uncertainties and caveats already noted in this Cabinet paper, the regulatory proposals recommended in this paper:

- are required in the public interest
- will deliver the highest net benefits of the practical options available, and
- are consistent with our commitments in the Government statement *Better Regulation, Less Regulation*.

## Publicity

42. The key aspects of this proposal will be announced as part of Budget 2012. Inland Revenue will publish details about the new legislation in the *Tax Information Bulletin* when the amending legislation is enacted.

## Recommendations

43. It is recommended that Cabinet:

1. **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).
2. **Agree** that, subject to recommendations 3 and 4 below, the deductions claimed against the income derived from a mixed-use asset be apportioned based on the actual income-earning use divided by the actual total use of the asset.
3. **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.

4. **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 only be able to be carried forward and offset against future profits from that asset.
5. **Agree** that the proposed rules apply 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), noting that additional rules will be needed to deal with specific interest deduction and imputation issues that arise with companies.
6. **Agree** that the approach in recommendation 2, without the limitations set out in recommendations 3 and 4, also be used for calculating a registered person's GST input tax deductions.
7. **Agree** that legislation to implement the proposed changes be included in the omnibus taxation bill, proposed to be introduced around July 2012, and to take effect from the commencement of the 2013-14 income year.
8. **Note** the following changes as a result of the decisions in paragraphs 1 – 7 have the following impact on the operating balance:

\$m increase/(decrease)				
	2012/13	2013/14	2014/15	2015/16 & outyears
Tax Revenue: mixed use assets	0.000	9.000	50.000	50.000

9. **Agree** that the fiscal impact described in paragraph 8 be used as a savings item in Budget 2012.
10. **Agree** that the Ministers of Finance and Revenue be authorised to make decisions on the detail of these proposals without further reference to Cabinet.

**Hon Bill English**  
Minister of Finance

**Hon Peter Dunne**  
Minister of Revenue

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Date

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Date