Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Briefing note

Date: 31 March 2010

To: Olivia Williams and Mike Nutsford

From: Matt Benge and Steve Mack

Subject: Taxation of residential rental property

The Tax Sub-Group Ministers have expressed concern about whether there might be over investment in rental property even with the package of measures to be included in Budget 2010. This note outlines what is being done to address these concerns as part of Budget 2010 and additional measures could be considered.

What is planned

Budget 2010 contains a number of measures that will directly or indirectly affect the tax treatment of residential property investment. These are:

- removing depreciation from buildings with an estimated useful life of 50 years or more from the 2011/12 income year;
- Loss Attributing Qualifying Companies (LAQCs) will become flow-through entities for income tax purposes for income years commencing on or after 1 April 2011 (prevents losses flowing through at investors marginal tax rate and income being taxed at the lower company rate);
- committing additional resources to fund additional audits of the residential property sector;
- Investment losses (including those from rental property) will not be able to be used to reduce income for Working for Families calculation;
- GST base maintenance options including addressing phoenix scheme fraud (phoenix scheme fraud often involves real property); and
- a reduction in personal marginal tax rates (reduces the value of tax losses).

Ideas where no further work is planned

As part of Budget 2010, the government has considered, and decided not to proceed with the following list of measures (the first three were rejected in the Prime Minister's February speech and subsequent Cabinet decision on the shape of the Budget tax package):

- A broad based capital gains tax;
- RFRM on residential rental property;
- A broad based land tax;
- A bright-line test for residential rental property;
- Loss ring fencing rules for residential rental property.

Further ideas

We have identified the following measures where further work could be done beyond Budget 2010. These measures could be announced as part of Budget 2010.

- Impose a minimum tax on all rental property. This would involve setting an annual minimum taxable income based on a percentage (say 1% or 2%) of the residential property's total value (either gross or net equity). Landlords would also calculate actual taxable income in the normal way. Tax would be paid on the higher of the amount of actual taxable income or the minimum taxable income. This approach raises a number of issues that would need to be considered prior to any announcement being made. For example, rules would be needed to prevent taxpayers allocating interest expenditure to assets other than residential rental property in an attempt to maximise the tax value of interest deductions. This measure also raises implementation issues similar to loss ring-fencing and we don't recommend it for Budget announcement.

- Better apportionment rules for rental properties acquired for both private and business purposes. Rules could be developed that allocate expenditure in ways that better reflect the amount of gross income being derived – for assets acquired for both private and business purposes. At present a property may be acquired predominantly as a holiday home but rented out for some period. For example, the property might be used as a holiday house by the owner for 4 weeks of a year and available for rent for the remaining 48 weeks although only rented out for 2 weeks. In that case, because the property is available for rent for 48 weeks, 48/52ths of its expenses (such as interest, rates and repairs and maintenance) might be deducted. This might be viewed as excessive. It might be possible to restrict deductions where properties are partly used for private purposes and where they are actually rented out for only short periods within a year. Using the earlier example, it might be possible to allow only 2/52ths of expenditure to be deductible. Another approach would be to allow deductions only where rental revenue is greater than some small proportion of the property's capital value. While further work on a number of issues would be required, our initial view is that this proposal is worth further consideration. We will advise you when Budget material is being prepared whether announcements on post-Budget work on the tax treatment of residential housing should be made.

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