Tax and property - ring-fencing rental losses

For rental properties that make losses, owners can no longer offset those losses against other sources of income such as salary or wages, when calculating income for tax purposes.

However, owners who incur losses on their rental property can carry those forward and use them against future income or profits from that property. Owners with more than one property can also use those losses to offset income from other rental properties.

What property is subject to these rules?

The rules apply to 'residential rental property':

- land that has a dwelling on it
- land on which the owner has arranged to build a dwelling, or
- bare land that may be used to build a dwelling under the relevant operative district plan

What property is NOT subject to these rules?

The rules do not apply to property that is:

- used predominantly as business premises, or farmland
- a person's main home
- land subject to the mixed-use assets rules (such as a bach that is sometimes used privately and sometimes rented out)
- land owned by a widely held company
- accommodation provided to employees or other workers because of remote location or equivalent reason
- land identified as taxable on sale (such as land held in dealing, development, subdivision, and building businesses, and land bought with the intention of resale), provided that:
  - the taxpayer notifies Inland Revenue of their rental income and expenditure on a property-by-property basis, or
  - the taxpayer notifies Inland Revenue of their rental income and expenditure on a portfolio basis and all the properties within the portfolio are on revenue account.

Offsetting rental losses within a portfolio

If you own more than one rental property, under the new rules a default method of ring-fencing deductions applies on a portfolio basis. You can offset deductions for a specific rental property against income from other rental properties in your portfolio, essentially calculating your overall profit or loss across your portfolio.

When all the properties within the portfolio are sold, if they were all taxed on sale (either in the current or an earlier income year), any unused deductions at that point can be used to offset against your other income (including wages or salary). However, if any of the properties were not taxed on sale, the unused deductions remain ring fenced.

If you don't want to proceed on a portfolio basis, you can elect to use a property-by-property basis.

Offsetting rental losses property-by-property

If you want to offset deductions for a specific property against future income or taxable gain from that same property, you must elect to do so. You do this by notifying Inland Revenue in your income tax return that you are applying the ring-fencing rules on a property-by-property basis. The 2019/20 income year is the first year you will be able to do this. For any property acquired after that, the

election to use the property-by-property basis must be made in the relevant tax return in the year the property is purchased.

If you use the property-by-property basis, you must set out income and deductions relating to each specific property in your returns to Inland Revenue. When the property is eventually sold, and if the sale is taxed, at that point any unused deductions can be used to offset other income (including salary or wages). Note, however that unused deductions will not be available to offset against other income where they have been transferred from another property and the disposal of that property was not taxed.

Transfer between companies in a wholly-owned group

Where you own multiple companies, and those companies' assets include residential property, it will be possible to transfer rental losses from one company to another. The deduction would only be able to be used by the transferee company for residential rental income (or the sale of residential land that is taxable). Note that the companies must belong within a wholly-owned group.

Interposed entities

Some businesses do run complex entity structures involving companies, trusts, or partnerships alongside the actual people at the heart of the business.

Specific rules deal with residential rental properties held by 'interposed entities' (such as companies, trusts, partnerships, and look-through companies). In the absence of these rules a person could avoid the ring-fencing rules by using an interposed entity.

For instance, where a person takes out a loan to buy shares in a company that then buys a residential property, in theory the person could claim deductions on the interest because the loan relates to investment in shares rather than buying a rental property. The person could then offset those deductions against other income (such as salary or wages).

The interposed entity rules target deductible interest on funds borrowed to acquire a 'residential land-rich entity'. A residential land-rich entity would include a close company, partnership, look-through company or trust that has residential land as more than 50% of its assets. The result is that the person borrowing funds is limited as to how much interest they can deduct. Any portion that exceeds the rental income from the property is ring-fenced and carried forward to a later income year in which the person receives residential income.

Keep in mind

The rules on the taxation of residential property are complex and have been subject to great change over the last few years. Even the nature of what constitutes a deductible loss is shifting, with the introduction of interest limitation rules relating to mortgage interest on residential investment property. Let us know if you require details on these rules.

Don't hesitate to contact us if you want to discuss the impact on your rental investments, and if you:

- are thinking about buying or selling rental property
- are arranging finance or refinancing your rental property