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Ring Fencing Rules & Tax Policy Update

Recently, new subpart EL of the Income Tax Act 2007 introduces rules to ring-fence deductions for residential properties to income from those properties.

Overseas property

The new ring-fencing rules apply to residential rental properties which include overseas property held by a New Zealand tax resident. This is because it would not be equitable for deductions for loss-making overseas residential rental investments to be able to be offset against income in New Zealand, but deductions from loss-making domestic residential rental investments not to be.

Options for owners of more than 1 rental property

If investors own more than 1 residential rental property, they can choose whether to apply the rules across their portfolio of properties, or to apply them on a property-by-property basis.

The default position is that the ring-fencing rules apply on a portfolio basis. Under this approach, the investors calculate their overall profit or loss across all the properties in their portfolio. The income from all properties in the portfolio is offset by deductions for all properties.

Alternatively, taxpayers can elect to apply the ring-fencing rules on a property-by-property basis. This approach can be elected for one or more of the taxpayer's residential rental properties, even if they own other properties which are part of a portfolio.

When using the property-by-property approach, each property is looked at separately and deductions for one are not able to be offset against income from another. In the return that reflects deductions for the particular property only being used against income from that property. Expenditure to which any deductions relate must relate solely to the particular property. So, if for example, there is some expenditure that related to more than one property (e.g., interest on a loan used for two properties) the property-by-property basis could not be used.

The basis used when the property is owned by a look-through company (LTC) or a partnership

LTCs

If the residential property is owned by an LTC, whatever basis the LTC has applied the ring-fencing rules on in filing its return will flow through to and be binding on the shareholders.

So, if an LTC applied the rules on a portfolio basis and the portfolio was loss-making overall, any shareholder who directly held other residential property subject to the ring-fencing rules would be able to use their share of the deductions that flow through from the LTC against their total residential income. This would include their residential income from the LTC and any other residential income they derive.

If an LTC applies the rules on a property-by-property basis, the shareholders have to also take that approach in their returns. This would mean, if residential deductions for the property exceeded the residential income from the property, the shareholder could only use their share of the deductions up to their share of the income from the property. Their excess deductions would not be able to be used against residential income from another property.

Partnerships

For partnerships, no specific flow through provision for elections as there is for LTCs. If a partnership has filed a partnership return applying the rules on a particular basis, the partners do not necessarily need to apply the rules on that same basis. And different partners in the partnership may potentially apply the ring-fencing rules on different bases in respect of their share of the residential income and deductions.

If the partnership has more than one property and a partner wants to use the property-by-property basis the partnership must be able to separate expenses to each property. If the expenses are intermingled the partners cannot use the property-by-property basis for their share of the partnership properties.

Talk to us about which approach is best for you.

If you would like to know more or require assistance please contact Kirit or Alannah.