

QUESTIONS WE'VE BEEN ASKED

QB 09/02: HOLIDAY HOUSES — INCOME TAX TREATMENT

All references are to the Income Tax Act 2007.

Question

We have been asked about the correct income tax treatment when an individual owns a holiday house and rents it out from time to time.

Answer

The following answer necessarily sets out general principles only. The facts of particular cases always need to be considered carefully, and it may be necessary to obtain advice from a tax advisor.

Rental income

Any rental income received is taxable under section CC 1 and should be returned in the owner's tax return for the income year in which it is derived. This legislative provision taxes any rental income derived from the leasing or licensing of land (and land includes any house on that land), regardless of whether the activity amounts to a business or whether market rates are charged.

Deductibility of expenses

Whether any expenses incurred in owning the holiday house are deductible, depends on their connection with the income earned. Under section DA 1, a person is allowed a deduction for an amount of expenditure or loss (including an amount of depreciation) to the extent to which the expenditure or loss is incurred in deriving their assessable income. However, a person is denied a deduction to the extent to which the expenditure is private in nature: section DA 2(2). Deductions are also not available for costs that are capital in nature: section DA 2(1).

In the case of a holiday house that is rented out for only some of the income year, the owner's ability to deduct expenses such as interest, insurance, depreciation, and rates depends on the specific circumstances of the case and whether the expenses have sufficient connection with the earning of rental income.

If the holiday house is rented to a tenant on an arm's length basis for a long-term stay, then the owner is generally able to apportion those costs on a time basis. For example, if the holiday house is rented for six months of the year, then any interest charges that relate to that period and the depreciation costs, insurance, and rates that relate to that period are deductible.

If the holiday house is available for rent for only some parts of a year, the ability to deduct a proportion of those expenses depends on the degree of connection the expenses have with the earning of income (as compared with the private ownership of the holiday house).

If a holiday house is essentially available only to the owner and their family and friends, so it is available to rent to third parties on only a limited basis, then Inland Revenue will apply the following principles.

- The owner is not entitled to claim a deduction for expenses incurred for the periods the holiday house is not rented.
- If the holiday house is rented out on an arm's length basis, (unless there are particular circumstances that would suggest the holiday house is not being genuinely used as an income-earning asset), an owner can claim a proportion of the expenses incurred equal to the time that the holiday house was actually rented (unless the nature of the expenses are such that the taxpayer can show that a different basis of apportionment would be appropriate, for example, a power bill that relates to actual useage may be more appropriately spread over the days that the property was actually occupied). If one or more parts of the holiday house are not available to be used by the person renting the holiday house (eg, a room is used to store the owner's personal possessions and it is locked so only the owner can access it), then a deduction is available only for the proportion of the holiday house that is available for use by the person renting the holiday house.
- In cases where a holiday house is used by friends or family who are not charged rent, but instead make a minor contribution towards the owner's expenses, this payment will generally not be rental income. Consequently, the owner will not be required to return the amount received, but nor will any deductions be allowed for the corresponding period. If a holiday house is rented for less than a full market rental, such as to family and friends, the Commissioner will accept a deduction for that period up to the amount of rent received for that period.

Evidence of a holiday house being available for rent generally needs to be more than a mere statement of its availability, sporadic or limited advertising, or advertising

that is of a nature that is unlikely to attract many customers. Rather, there must be evidence of active and regular marketing of the holiday house at market rates and of the availability of the holiday house at times and for periods that demonstrate the holiday house is earning rental income or is genuinely available to earn rental income. Therefore, any expenditure incurred, which is potentially deductible, is not denied because it is private.

If a holiday house is available for only limited and/or undesirable periods and/or at non-competitive rates, such factors tend to indicate that the expenditure is not incurred in deriving assessable income.

In terms of meeting the statutory test, if the holiday house has mixed uses, the ability to deduct expenditure comes down to a case-by-case assessment that weighs all the evidence. Objective evidence is required that the holiday house is genuinely available for rent and that there is a real prospect of occupancy and rental income being earned. This needs to be considered separately in relation to each year (ie, just because a holiday house has been genuinely available for rent and sufficiently marketed and/or actually rented in one income year, does not mean a deduction will be automatically allowed in subsequent income years).

Example 1

A holiday house in the Coromandel has earned significant rental income after active marketing at competitive rates in newspapers and on internet sites for almost all of the year. However, the owner's family uses the holiday house for two weeks over the Christmas/New Year period. Even though, in this case, the holiday house may not be actually rented out for every day of the remaining 50 weeks, provided it is available for rent during those 50 weeks, it is generally possible to deduct expenses for that period (ie, for 50 weeks out of the full year). Any expenses that are variable in nature (ie, incurred when the property is occupied) should be spread on an appropriate basis.

Example 2

A holiday house in Mount Maunganui is used by its owner and her friends and family for most of the year. However, the holiday house is rented out to a third party for two weeks over the Christmas/New Year period for \$3,000. In this case, the owner may deduct expenses (eg, interest charges, depreciation costs, insurance, and rates) for the proportion of the year that the holiday house was actually rented out (ie, for two weeks out of 52 weeks). Any expenses that are variable in nature (ie, incurred when the property is occupied) should be spread on an appropriate basis.

Example 3

A holiday house in Queenstown is available to be rented for eight weeks a year when it is not being used by the owner. For four of those weeks it is rented to members of the public for its market rental of \$600 per week. For the remaining four weeks it is rented out to a family friend. The friend is charged "mates rates" of \$350 per week. In this case, the Commissioner would accept the owner deducting expenses (eg, interest charges, depreciation costs, insurance, and rates) for the proportion of the year that the holiday house was rented to the friend (ie, for four weeks out of 52 weeks) up to a maximum of \$1400 (the amount of rent received). Full deductibility would be allowed for the remaining four weeks that the property is rented out.

Example 4

A holiday house in Papamoa is used by the owner for most of the year. A market rental for the property would be approximately \$450 per week. The holiday house is made available for use by a family friend for three weeks during summer. The friend is not charged for staying at the property, but chooses to make a contribution of \$200 to the owner towards the cost of power, water, etc for the three weeks. In this case, the amount received is not income of the owner and, consequently, does not need to be returned to Inland Revenue (nor would any tax return need to be filed – unless the owner otherwise had to file one). Similarly, no deductions are available to the owner.

Item provides general guidance only

This item provides general guidance only. This item also does not consider any possible Goods and Service Tax consequences of renting out a holiday house. Individual circumstances are inevitably different. The Inland Revenue Department suggests that anyone considering purchasing a holiday house and intending to rent it, seeks advice from a tax advisor.