Deductibility of Holding Costs for Privately Used Land Taxable on Sale

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New Zealand tax law is currently unclear on whether holding costs (such as mortgage interest, rates, insurance, repairs and maintenance) are deductible where they relate to privately used land that is taxable on sale. The Inland Revenue Department (IRD) has been denying such deductions in these circumstances. This issue has become particularly relevant since the introduction of the bright-line test, which has brought a significant amount of privately used land into the tax base. The IRD’s stance means, for example, that New Zealanders cannot deduct holding costs if they are taxed on the gain from the sale of their private holiday homes. This article scrutinises whether the IRD’s position is legally supported. It proposes and assesses three interpretations of the relevant law. First, holding costs are fully deductible for periods of private use. Secondly, holding costs are not deductible for periods of private use. Thirdly, holding costs are partly deductible for periods of private use, based on an apportionment between the gain on sale and the value of the private benefit. This article evaluates each of these three interpretations based on their consistency with legislation and case law, fairness and equity, and simplicity and practicality. It concludes that the IRD’s approach of denying deductions is based on an overly literal interpretation of the legislation and does not place landowners in a fair position. While apportionment is the most principled and elegant approach, it is complex to apply and enforce. Allowing full deductions for holding costs is both simple and fair, and is therefore the best interpretation. Regardless, New Zealand landowners should challenge the IRD’s steadfast approach of denying deductions so the issue may be judicially considered.

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I Introduction

Suppose a New Zealand couple purchases a second property on a coastal beachfront to use as their private holiday home. If they sell this property within five years, the gain on sale is taxable under the bright-line test. Although the cost of capital improvements to the property are deductible, the Inland Revenue Department (IRD) currently denies deductions for holding costs (such as mortgage interest, rates, insurance, repairs and maintenance) on the basis they are private in nature.1

This article challenges the IRD’s approach and asks whether, and to what extent, holding costs are deductible where they relate to land that is privately used but taxable on sale. It offers three interpretations of the law. Holding costs are:

- fully deductible for periods of private use;
- not deductible for periods of private use; or
- partly deductible for periods of private use, based on an apportionment between the gain on sale and the value of the private benefit.

The article evaluates each of these interpretations based on their consistency with legislation and case law, their fairness and equity, and their simplicity and practicality as an approach in New Zealand tax law. It concludes that denying deductions, while consistent with a literal interpretation of the legislation, does not place landowning taxpayers in a fair position. Apportionment is the most principled approach but appears complex to apply and enforce. Allowing full deductions is both simple and fair, and is therefore the best interpretation.

II The Issue

A Background

Holding costs are costs such as mortgage interest, rates, insurance, repairs, maintenance and other non-capital expenditure incurred as part of land ownership.2 The “general permission” of tax law states that expenditures are deductible to the extent that they are incurred in deriving assessable income.3 This means holding costs are fully deductible if the property is solely used to generate rental income.4 They are also deductible if the land is part of a land dealing business because those costs relate to the taxable income from land sales.5 However, the “private limitation” of tax law states that expenditures are not deductible to the extent that they are of a private or domestic nature.6 This means holding costs relating to a person’s home that is solely used privately are not deductible.

Because deductibility is permitted “to the extent” that the expenditures are incurred in deriving assessable income and denied “to the extent” that they are of a private nature, expenditures may be apportioned where a property has dual purposes.7 For example, if

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1 Inland Revenue Tax Information Bulletin (Vol 28 No 1, February 2016) at 88.
2 Inland Revenue Holding costs for privately used land that is taxable on sale: A tax policy consultation document (October 2019) at [1.3].
3 Income Tax Act 2007, s DA 1(1).
4 Section CC 1(2)(a).
5 Section CB 1.
6 Section DA 2(2).
7 Buckley & Young Ltd v Commissioner of Inland Revenue [1978] 2 NZLR 485 (CA) at 497–498.
one-third of a property’s floor area is set aside to run a music tuition business, and the rest is used as a private home, one-third of the general holding costs would be deductible against the business revenues. Similarly, if a property is fully rented out for six months a year and used privately for six months, half the holding costs would be deductible against the rental income. The other half is not deductible because it was not incurred in producing assessable income.

B The issue

Although the above is settled law, the law is currently unclear on whether holding costs are deductible where they relate to land that is privately used and taxable on sale. The main scenario in which this issue arises is where privately used land (such as a holiday home) produces a gain on sale taxable under the bright-line test. The IRD has stated that due to the private limitation, holding costs are not deductible where the land is used privately. However, this seems unfair, as the costs relate to revenue account property that produces assessable income on sale. Under the IRD’s approach, if a person only uses their holiday home privately, no holding costs are deductible even though the capital gain is taxed on disposal. If a person rents out their holiday home 10 per cent of the time, only 10 per cent of the holding costs are deductible (against the rental income), even though the entire capital gain is taxed.

It is agreed that in these circumstances, the cost of the property, the incidental costs of acquisition and disposition, and the cost of capital improvements are deductible in calculating the taxable gain. Only the deductibility of holding costs (expenditures of a revenue rather than a capital nature) are in issue.

The article will focus on ownership of land by individuals but applies equally to partnerships and trusts. As an aside, companies are entitled to deduct interest (the largest holding cost), notwithstanding the general permission. Despite the inequity between companies and other ownership structures, there are existing rules that disincentivise company ownership of private land, so the disparity is not a concern.

The next Part will explore various situations where privately used land is taxable on sale, before discussing to what extent holding costs are, or ought to be, deductible.

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8 Note that apportionment only applies to expenses that relate to both the income-earning and private use such as insurance, rates, interest and general maintenance for wear and tear. If the expenses relate fully to the income-earning use—for example, cost to repair damage to the music studio caused by students—they are fully deductible.

9 Inland Revenue, above n 2, at [2.2].

10 See Income Tax Act, s CB 6A.

11 Inland Revenue, above n 1, at 88.

12 Income Tax Act, s DB 23.

13 Factors suggesting an expenditure is of a capital nature include whether it is a once-and-for-all (as opposed to recurrent) expenditure and whether it produces an identifiable asset or an enduring benefit. New Zealand Master Tax Guide (Wolters Kluwer CCH, Auckland, 2020) at [10-075].

14 Income Tax Act, s DB 7.

15 If land is privately used by shareholders, the shareholders must pay full market rent to the company, which is taxable to the company but non-deductible to the shareholders. The dividend income to shareholders is also taxable. If land is privately used by employees, the benefit to the employees is taxable either as employment income or subject to fringe benefit tax. Income Tax Act, ss CD 1 and CX 23(2)(c).
III The Context: Scenarios Where Privately Used Land is Taxable on Sale

To contextualise and illustrate the significance of the issue, this Part provides examples of scenarios where the sale proceeds of land are taxable even though the land was privately used.

A The bright-line test

The bright-line test in s CB 6A requires income tax to be paid on gains from the disposal of residential property acquired and disposed of within five years, subject to certain exceptions. It was introduced in 2015 to supplement the s CB 6 test, which taxes gains on land acquired with a purpose or intention of disposal. However, its requirement of proof of subjective intent made enforcement difficult. The bright-line rule was designed to be an unambiguous objective test to make it easier to target short-term speculation in residential property.16 Land will be taxable on sale if the following criteria are met.

1. Satisfies bright-line test (s CB 6A)

Land may be taxed under the bright-line test if the bright-line period—generally beginning at the registration of title for purchase and ending at the contract to sell—is less than five years. The bright-line period is two years for land acquired before March 2018. The test only applies to residential land.

2. Main home exclusion (s CB 16A) does not apply

The bright-line test does not apply if the property falls under the main home exclusion in s CB 16A. The exclusion saves many homes from taxation and was important to the political feasibility of the bright-line policy.17 However, there are several circumstances where residential land may be privately used but does not meet the exclusion and, is therefore, taxable under the bright-line test (and therefore engage the holding cost deductibility issue).

(a) Not a main home: s CB 16A(1)

The first is where the residential land does not amount to a main home. This may be because it was not used predominantly and for most of the time by the person owning the land for a dwelling that was their main home.18 Suppose Alex owns an apartment block on a single title. She lives in one of the apartments and rents out the other three. The main home exclusion would not apply, as the land was not used predominantly as her main home—she occupied less than 50 per cent of the physical area.19 Now suppose Ben and his family live in Tauranga, but because Ben works in Auckland, he stays in an Auckland apartment he owns for three nights a week. The main home exclusion will not apply to this apartment because he resides there less than 50 per cent of the time. The same goes for

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16 Inland Revenue Regulatory impact Statement: Bright-line test for sales of residential property (7 August 2015) at [13].
17 At [39].
18 Income Tax Act, s CB 16A(1).
19 Inland Revenue, above n 1, at 84.
Claire who owns a bach but only uses it over the summer holidays.\textsuperscript{20} Note that the main home exclusion either applies or does not apply—there is no option of apportionment. A person can only have one main home.\textsuperscript{21} Furthermore, the exclusion does not apply if it was not the owner, but say a family member, that used the property as the main home.\textsuperscript{22}

If the property is owned by a trust, the trustee can use the exclusion when disposing of the main home of a beneficiary of the trust. However, the exclusion does not apply if the principal settlor has another main home.\textsuperscript{23} Suppose David has two properties, a family home and a flat his son lives in while studying. He settles the flat on a trust and makes his son a beneficiary. The trust cannot use the main home exclusion because the principal settlor, David, has another main home. This rule prevents people from using trusts to exploit the availability of the exclusion to avoid bright-line tax liability.

Sometimes the sale of a section subdivided from residential land may not meet the requirements of the main home exclusion and therefore be taxed under the bright-line test.\textsuperscript{24} It is not the case that the exclusion never applies to a subdivided section—it does apply where the section, prior to subdivision, was used predominantly and for most of the time as the owner’s main home. So, if Erin subdivides her main home and continues to use the subdivided section as her backyard, she can use the exclusion when she sells the backyard section. However, suppose Finn buys his main home and three months later, subdivides the land and immediately begins to construct a new dwelling on it. When he sells the subdivided section a year later, he cannot rely on the exclusion because the section was not used predominantly and for most of the time as his main home.\textsuperscript{25}

(b) Main home exclusion is not available: s CB 16A(2)

Even if the land was the owner’s main home, the main home exclusion will not be available if the owner is a habitual seller. This occurs when the exclusion has been used by the owner twice in the previous two years from the date of the property’s disposal.\textsuperscript{26}

It also occurs where the owner has “engaged in a regular pattern of acquiring and disposing” main homes.\textsuperscript{27} According to Tompkins J in \textit{Parry v Commissioner of Inland Revenue}, “‘[p]attern’ denotes a similarity or likeness in the transactions.”\textsuperscript{28} The Court will consider factors such as the location of the land, the type of dwelling houses on it and the uses to which they were put.\textsuperscript{29} For a pattern to be regular the transactions must occur at “sufficiently uniform or consistent intervals”.\textsuperscript{30} Generally, at least three prior transactions are required to establish a regular pattern.\textsuperscript{31}

\begin{itemize}
\item \textsuperscript{20} A “bach” is an informal New Zealand term for a small holiday house.
\item \textsuperscript{21} Income Tax Act, s YA 1 definition of “main home”.
\item \textsuperscript{22} Section CB 16A(1)(a).
\item \textsuperscript{23} Section CB 16A(1)(b).
\item \textsuperscript{24} The bright-line period for the subdivided section does not begin when that subdivided section is registered, but when the original transfer of the undivided land to the taxpayer was registered. See Section CB 6A(2).
\item \textsuperscript{25} Inland Revenue \textit{Income tax – bright-line test – main home exclusion – sale of subdivided section} (QB 18/16, 19 December 2018) at 1.
\item \textsuperscript{26} Income Tax Act, s CB 16A(2)(a).
\item \textsuperscript{27} Section CB 16A(2)(b).
\item \textsuperscript{28} \textit{Parry v Commissioner of Inland Revenue} (1984) 6 NZTC 61,820 (HC) at 61,824.
\item \textsuperscript{29} At 61,824.
\item \textsuperscript{30} Inland Revenue \textit{Habitual buying and selling of land: A tax policy consultation document} (September 2019) at [14].
\item \textsuperscript{31} Inland Revenue \textit{Tax Information Bulletin} (Vol 28 No 9, October 2016) at 4.
\end{itemize}
To illustrate, consider Couple G, who buy a home, renovate it while occupying it, then sell it after two years. They repeat this three times. This establishes a “regular pattern” because the transactions had a similar likeness (all involved renovation during occupation). Consider Couple H: their first property is bought, lived in and sold; the second is renovated while it is lived in and sold; and the third is a bare section where a house is built, occupied and sold. The transactions were regular but not similar enough to be a “pattern”.\(^{32}\) Suppose each couple then moves into their fourth home and sells it within five years. Couple H can use the s CB 16A(1) main home exclusion to avoid taxation under the s CB 6A bright-line test. However, for Couple G, the s CB 16A(2) regular pattern restriction precludes their ability to use the main home exclusion, meaning they will be taxed under the bright-line test.

### B  Dealers, developers or builders’ other land

(1) Satisfies ss CB 9, CB 10 or CB 11

In limited circumstances, gains on the private properties of dealers, developers and builders may be taxed, even if the properties were solely for personal use.

Section CB 9 states that gains from the disposal of land are taxable income if: (a) the person disposed of the land within 10 years of acquiring it, and (b) they, or an associate, carried on a business of dealing in land at the time they acquired the land. This applies regardless of whether the land was acquired for the purpose of the business. Section CB 10 is an identical provision targeting those in the business of developing or subdividing land, and s CB 11 applies to those in the business of erecting buildings.

(2) Residential exclusion (s CB 16) does not apply

To avoid unfairness to dealers, developers and builders, s CB 16 states that ss CB 9 to CB 11 do not apply if they acquired the land with a dwelling house on it and occupied it as their residence. However, there are conceivable scenarios where the land is used privately but does not meet the requirements of this residential exclusion, meaning its proceeds of disposal are taxed.

First, the exclusion does not apply if the dwelling house was not occupied by the owner (it may have been used by a family member or left vacant).\(^ {33}\) Second, it does not apply to land related to the dwelling house land if its area is greater than 4,500m\(^2\) and the larger area is not required for the reasonable occupation and enjoyment of the dwelling house.\(^ {34}\) Third, it does not apply where the owner has engaged in a regular pattern of acquiring and disposing dwelling houses.\(^ {35}\)

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32 Inland Revenue is proposing to “expand the regular pattern restrictions” so that it no longer requires a similarity or likeness between transactions (suggesting Couples G and H will be treated in the same way). See Stuart Nash *Taxation (Annual Rates for 2020–21, Feasibility Expenditure, and Remedial Matters) Bill: Commentary on the Bill* (Inland Revenue, June 2020) at 19–23.

33 Income Tax Act, s CB 16(1)(b).

34 Section CB 16(2).

35 Section CB 16(3). The “regular pattern” test for the residential exclusion is the same as that for the main home exclusion.
C Land with rezoning gains

Under s CB 14, the proceeds of sale of land is taxable income if (a) the person disposed it within 10 years of acquiring it and (b) 20 per cent or more of the gain during the holding period was attributable to a change in the rules of an operative district plan, a grant of consent, the removal of a covenant or factors of a similar nature.

Although s CB 14 is subject to the s CB 18 exclusion for residential property, this exclusion only applies if the taxpayer disposed of the land to someone who also acquired it for residential purposes. Suppose Gemma owns her house for six years and during this period its value appreciates by $300,000. More than 20 per cent of this gain is due to the Auckland Unitary Plan which upzones her neighbourhood to allow intensification. If Gemma sells her property to a buyer who does not intend to use it mainly for residential purposes but, say, to operate a hair salon business, the $300,000 gain would be taxable income, even though Gemma has used the property as a private residence.

D Summary and approach

As shown, there are various scenarios where capital receipts from the disposal of land are treated as taxable income by the Income Tax Act 2007 even if the land was privately used. In these scenarios, it is unclear whether the holding costs are deductible—they relate to the earning of taxable income but are also private expenditures. Broadly, there are three possible interpretations of the law:

- holding costs are fully deductible, even though there is private use;
- holding costs are not deductible for periods of private use; or
- holding costs are partially deductible, apportioned between the gain on sale and the value of the private benefit.

All three are plausible interpretations of the Income Tax Act. However, the second is the one held by the IRD and indicated in the legislative history. The following sections will evaluate which is the best interpretation by analysing their consistency with existing legislation and case law, their fairness and equity, and their simplicity and practicality.

IV Interpretation One: Allow All Deductions

This option states that holding costs are fully deductible, despite any private use, on the basis that they were incurred in deriving assessable income.

A Satisfies the general permission

The general permission states that expenditures are deductible to the extent that they are incurred in deriving assessable income. The proceeds from the sale of the properties

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36 Section CB 18(1)(b). Whether this rule should be amended is a separate issue to be considered.
37 Upzoning allows owners to “more densely develop their land through zoning changes”, thereby “increasing the potential number of dwellings on the land”. Shane Martin and David Norman How the Unitary Plan adds value to properties (Auckland Council, October 2017) at 1.
38 Inland Revenue, above n 1, at 88. Todd McClay Taxation (Bright-line Test for Residential Land) Bill: Commentary on the Bill (August 2015) at 20, stated “if a person purchases a bach for family use … the holding costs would not be deductible because of the private limitation”.
39 Income Tax Act, s DA 1.
discussed in Part III are assessable income. Therefore, holding costs should be deductible to the extent that they are incurred in deriving the property’s taxable gain.

(1) Nexus exists

The general permission is satisfied where there “is a sufficient relationship between the expenditure and what it [provides] ... and the income earning process”. The author argues that this nexus exists between holding costs such as interest, rates, insurance, repairs and maintenance costs on the one hand, and the value of the land and the taxable income on sale on the other.

For example, many repairs and maintenance costs, while not amounting to capital improvements (which are deductible), are nonetheless critical in maintaining the value of a property, thereby enabling it to produce a gain on sale. Examples include the replacement of carpets due to wear and tear, the refitting of windows due to rotting framing, or the plastering and painting of cracked walls. These works do not cross the threshold of capital improvements as they do not change the character of the assets. However, they nonetheless make good wear and tear to enable the continued usage of the assets and help retain the value of the property. Suppose Harry notices that his asbestos roof has cracked and has started leaking. Because asbestos is no longer appropriate as a roofing material, he replaces it with a comparable steel roofing product. Even though a more modern material was used, this reflects current building practices and did not improve the asset beyond its original condition. The works were revenue in nature, but nonetheless enhanced the value of the property to create a gain on disposal. They were incurred in deriving assessable income and should be deductible against that income.

(2) Note on timing

A potential issue with this reasoning is that Commissioner of Inland Revenue v Banks established that whether the general permission is satisfied or not must be assessed at the time the expenditure occurred. Some may argue that at the time the taxpayer incurred the holding costs, they may not have even known that the property would produce assessable income, so the general permission is not satisfied.

However, this is not a concern. The provision that allows deductions for the cost of purchase and of capital improvements (s DB 23) is also subject to the general permission being satisfied. However, many landowners would not know at the time of purchase that their property would one day produce assessable income. Nevertheless, deductions for the cost of purchase and improvements have always been allowed (and rightfully so). This shows that the Banks requirement is not strictly adhered to in this context, and the above analysis still stands.

40 Commissioner of Inland Revenue v Banks [1978] 2 NZLR 472 (CA) at 478.
41 Income Tax Act, s DB 23.
42 Examples adapted from Inland Revenue Income Tax – Deductibility of Repairs and Maintenance Expenditure – General Principles (IS 12/03, 29 June 2012) at [175].
43 See Auckland Gas Co Ltd v Commissioner of Inland Revenue [2000] 3 NZLR 6 (PC) at [24].
44 Commissioner of Inland Revenue v Banks, above n 40, at 477.
45 Income Tax Act, s DB 23(3).
(3) Appropriate holding costs only

For clarity, the author is not suggesting deductions should be allowed for all holding costs, but only those with a sufficient nexus to the taxable gain. This includes interest, rates, insurance, repairs and maintenance that are directed at preserving the value of the property. It does not include recurring maintenance, such as cleaning, gardening and pest control, or items such as power and utilities. These are more in the nature of consumables for the day-to-day enjoyment of the property. They are unrelated to the property’s capital value and there is no case for their deductibility.

Overall, allowing deductions for appropriate holding costs is consistent with the general permission. More broadly, it is a fair interpretation as it places taxpayers in the economically correct position by only subjecting the actual net gain to tax.

B Impeded by the private limitation

(1) Text of the legislation

However, this interpretation contradicts the private limitation in s DA 2, which denies deductions for expenditure “to the extent to which it is of a private or domestic nature”. In Commissioner of Inland Revenue v Haenga, the Court held:

An outgoing [expenditure] is of a private nature if it is exclusively referable to living as an individual member of society and domestic expenses are those relating to the household or family unit.

Expenditure on food, housing, clothing and travel between home and work is typically considered to be private and domestic in nature. The private limitation has also precluded deductibility for the cosmetics and suntan expenditures of a freelance model, the cost of the conventional work suits of a barrister, and the cost of a throat operation to remedy a speech defect of a self-employed actress.

Recall that the concern is with the deductibility of holding costs relating to taxable land used for private purposes, such as holiday homes, homes occupied by the owners’ relatives, or the main home of a person who had a regular pattern of buying and selling. If holding costs relate to privately used land, they must be private or domestic in nature. Just because an expenditure is necessary for deriving assessable income does not mean it cannot be private. For example, even though food is necessary for a self-employed businessman to earn income, food is for human sustenance, and therefore, private in nature.

Section DA 2(7) states that the private limitation overrides the general permission. This means that even though the holding costs in the Part III scenarios are incurred in deriving assessable income, their private nature means they are not deductible. This is the conclusion demanded by a literal interpretation of the legislation.

46 Commissioner of Inland Revenue v Haenga [1986] 1 NZLR 119 (CA) at 128.
50 Case F117 (1984) 6 NZTC 60,125 (TRA).
51 Case H31 (1986) 8 NZTC 289 (TRA) at 292.
(2) Evaluation: overcoming the private limitation?

It is unfortunate that the legislation explicitly states that the private limitation overrides the general permission. While some believe that it is “an important principle of New Zealand’s tax framework”\(^\text{52}\), on closer examination, the private limitation appears redundant.

It is universally agreed that items such as food and shelter should generally not be deductible. However, there is no need to rely on their private nature to preclude deductibility. The simpler answer is that they were not incurred in deriving assessable income—they were incurred to meet basic human needs. The expenditures lack the sufficient relationship to the income required by the general permission.

It is hypothesised that the attractiveness of the private limitation is that it helps clarify the scope of the general permission. The phrase “incurred in deriving assessable income” is vague and susceptible to creative argumentation by taxpayers wishing to claim deductions. The existence of the private limitation allows courts to dismiss frivolous claims more easily by reference to an independent rule more definite in scope—it is arguably easier to ascertain what is “private or domestic in nature”\(^\text{53}\) than what is not “incurred in deriving assessable income”. However, this means a rule preventing deductions for private expenditures does not have intrinsic justification, but merely exists to supplement the general permission and make it easier to apply.

The private limitation is all well and good if every expenditure that tends to be private in nature is unlikely to be incurred in deriving assessable income. For example, the arrangement works in the cases of the model’s cosmetics, the barrister’s suits and the actress’s throat operation—courts can deny these deductions on the basis they were not incurred in deriving income, supplemented by the fact they were private. However, the stipulation that the private limitation overrides the general permission (when the former is intended to support the latter) does not work in our land scenarios. Consider costs expended to repair a private holiday home. These costs were not incidental to the gain but had a direct relationship to it and are indeed incurred in deriving assessable income. Yet they are also private in nature.

The author suggests that the private limitation should either be deleted or be reframed to be subservient to the general permission. All that should matter is whether the general permission is satisfied.\(^\text{54}\) At most, an expenditure’s private or domestic nature is merely a factor suggesting it does not have a sufficient nexus to the income. But if this nexus exists, as it does for the holding costs of taxable land, the expenditure should be deductible.

(3) Pacific Rendezvous Ltd v Commissioner of Inland Revenue

This perspective is implicitly supported by the Pacific Rendezvous Ltd case.\(^\text{55}\) The taxpayer was a company which owned and operated a motel business. They decided to sell the units and obtained a loan to finance improvements to those units. These expenditures were made to obtain an enhanced price for the units in their eventual sale and to increase business revenues in the meantime. The project was successful and both purposes were achieved. The Commissioner apportioned the loan interest as expenditure for a dual

\(^{52}\) Inland Revenue, above n 2, at [2.8].

\(^{53}\) Income Tax Act, s DA 2(2).

\(^{54}\) Subject to the other limitations in s DA 2 of the Income Tax Act.

\(^{55}\) Pacific Rendezvous Ltd v Commissioner of Inland Revenue [1986] 2 NZLR 567 (CA).
purpose and allowed only one-quarter as a deduction. The issue was whether the interest was apportionable at all—whether a part of the interest, corresponding to the comparative weight of the capital purpose, was not deductible.

The relevant provision stated a deduction on interest is permitted “so far as … [the interest] is payable on capital employed in the production of the assessable income”. The Court noted that all the loan funds were spent on improvements which increased revenues, on assets fully committed to the regular motel business. All the funds were employed in the production of assessable income. The question was whether it mattered that the funds had a further and indeed dominant purpose of increasing the assets’ capital value. The Court held it did not. It is “both necessary and sufficient that the [expenditure] was employed in the production of assessable income”. As long as every dollar borrowed was directed at earning assessable income, it does not matter that the dollars also had another purpose such as capital improvement. The interest was fully deductible.

Pacific Rendezvous Ltd showed that the capital limitation cannot limit deductibility as long as all the funds were employed in earning assessable income, notwithstanding that they also had a capital purpose. This principle can be extended to argue that the private limitation cannot limit deductibility where all the holding costs were employed in deriving assessable income (the taxable gain), notwithstanding that they also had a private purpose (of personal enjoyment).

C Consistent with approaches in Australia and Canada

Allowing deductions is the approach most consistent with how Australia and Canada treat holding costs. Under the capital gains tax regimes of these jurisdictions, holding costs can reduce the capital gain that is taxed.

(1) Australia

In Australia, a capital gain or loss occurs on the disposal of assets such as land and buildings. There is an exemption for a dwelling that was the taxpayer’s main residence. However, privately used land not covered by the exemption (such as a holiday home or the dwelling of a dependent child) would still be taxed on disposal.

The capital gain equals the capital proceeds less the “cost base” of the asset. The cost base includes the cost of acquisition, incidental costs (such as accountancy and legal costs),

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56 At 568 per Cooke P.
57 The case was decided under the Income Tax Act 1976. Now, under s DB 7 of the Income Tax Act 2007, companies are entitled to fully deduct interest whether or not it satisfies the general permission or is capital in nature.
59 Pacific Rendezvous Ltd v Commissioner of Inland Revenue, above n 55, at 572.
60 At 572.
61 At 572.
62 At 572.
64 Section 118-110.
65 Sections 118-165–118-175.
66 Section 100-45.
capital expenditures and costs to establish or defend title. Most importantly for our purposes, the cost base includes “the costs of owning” the asset, which include:

(a) interest on money ... borrowed to acquire the asset; and
(b) costs of maintaining, repairing or insuring it; and
(c) rates or land tax ... and
(d) interest on money ... borrowed to refinance the money ... borrowed to acquire the asset; and
(e) interest on money ... borrowed to finance the capital expenditure ... incurred to increase the asset’s value.

These holding costs do not form part of the cost base if they are already deductible against, say, the rental income of a rental property. However, where the property was not used to produce assessable income, these holding costs are included in the cost base, thereby reducing the capital gain.

For example, Irene buys a holiday home for $700,000 and later sells it for $1 million. During her ownership period, she pays $200,000 in interest, rates and maintenance. Because the property does not generate income, its cost base is $900,000 and she is taxed on a capital gain of $100,000. Further, assume that James owns a holiday home in the same circumstances but rents it out for half the time. He can deduct half ($100,000) of the holding costs against the rental income, and include the other half that was not deductible in the cost base ($800,000) in calculating his capital gain ($200,000).

(2) Canada

Canada also allows holding costs to effectively reduce the gain that is taxed. Its capital tax regime taxes 50 per cent of realised capital gains from the disposition of land but exempts a taxpayer’s principal residence. The capital gain equals the proceeds of disposition less selling expenses, less the “adjusted cost base.”

Like Australia, the adjusted cost base includes the cost of the property, any incidental costs and capital improvements. It also includes “interest on debt relating to the acquisition of land” and “property taxes.” However, current expenses such as repair and maintenance costs cannot be added to the adjusted cost base. For most property owners, the interest on mortgage is by far the largest holding cost. Thus, allowing interest to be added to the adjusted cost base to reduce the taxable gain achieves a result substantially similar to allowing deductions for all holding costs.

Therefore, allowing holding costs to be deducted against sale proceeds in New Zealand would give taxpayers similar economic treatment as they would receive under the Australian and Canadian systems.

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67 Section 110-25.
68 Section 110-25(4).
69 Section 110-45(18). Otherwise, one expenditure is effectively used twice to reduce tax liability.
71 Income Tax Act RSC 1985 c 1, ss 40(2) and 54.
72 Section 40(1).
73 Section 53(1)(h).
74 Canada Revenue Agency Capital Gains 2019 (T4037, 2019) at 5.
D **Summary**

Allowing full deductions requires a strained reading of the Income Tax Act: the general permission is expressly overridden by the private limitation. However, it has been argued that the private limitation exists to support the general permission and should be subservient to it. This would allow holding costs, which are incurred in deriving assessable income, to be fully deductible. This approach is fair as it places taxpayers in the economically correct position by subjecting only the net gain to tax.

V **Interpretation Two: Deny All Deductions for Periods of Private Use**

The second option is to deny all deductions for holding costs for periods where land is used privately. If a holiday bach was reserved for private use, no deductions for holding costs would be allowed. If the bach was rented out two-thirds of the time and used privately for one-third of the time, two-thirds of the holding costs would be deductible against the rental income. However, none of the portion attributable to the private use would be deductible against the taxable gain.

A **IRD’s preference and current practice**

Denying deductions is the interpretation held by the IRD (which is unsurprising as it produces the most tax revenue). The absence of authorities challenging this official position means deductions are inevitably denied in practice. The IRD acknowledges “the law is currently unclear” and has sought submissions on the matter, but maintains that denying deductions would be the best option for consistency and simplicity.

In its proposal for the introduction of a capital gains tax in New Zealand, the Tax Working Group also recommended denying deductions for “costs incurred in connection with holding the land” where land is held for private purposes. However, no reasons of substance were given.

B **Conforms with the private limitation**

It is correct that denying deductions associated with periods of private use respects the private limitation. But one might argue that a proper reading of the legislation points to Interpretation Three of apportionment: the private limitation denies a deduction “to the extent” that an expenditure is of a private nature and the general permission allows a deduction “to the extent” that it is incurred in deriving assessable income. This implies the expenditure should be apportioned to a private, non-deductible portion and an income-derived, deductible portion.

However, one response is that s DA 2(7) expressly states that the private limitation “overrides” the general permission. They do not operate on an equal footing. As long as a dollar is private in nature, it is not deductible regardless of whether it is income-derived.
and no apportionment is permissible. This interpretation is the most consistent with the
natural and ordinary meaning of the words of the legislation.  

C Consistent with United Kingdom approach

Denying deductions is most comparable to how the United Kingdom treats holding costs
under its capital gains tax regime. A capital gains tax is charged on realised gains on the
disposal of assets. The private residence relief exempts gains on a taxpayer’s main
home. Chargeable gains are computed by taking the consideration received on the
disposal less allowable deductions. These deductions include the cost of the asset, the
incidental costs of acquisition and disposal, and the cost of capital expenditure incurred
to enhance the value of the asset or to establish or preserve title. The allowable heads
include the phrase “wholly and exclusively”, suggesting that strictly dual-purpose
expenditure is not deductible and apportionment is not permissible.

Expenditure is not allowed as a deduction for capital gains purposes in two situations.
First, where it is already allowed in computing profits or losses for income tax purposes.
Second, where it would be allowable but for some insufficiency of income. The first
phrase means holding costs are not deductible against the gain if they are already
deductible against, say, rental income—this is uncontroversial. More interestingly, the
latter provision means no deduction for capital gains purposes is allowed for expenditure
relating to a property where, had the property been held as a capital asset used in a trade,
the expenditure would be deductible in calculating the profits of that trade. To illustrate,
rates on a property are not deductible against the gain. That is because had the property
been part of a business, the rates would be deductible in calculating business profits.

In other words, revenue expenditure is not deductible for capital gains purposes.
Therefore, holding costs cannot be used to reduce taxable capital gains in the United
Kingdom.

D Undermines fairness and horizontal equity

As acknowledged by the IRD, denying deductions seems unfair “as it does not recognise
the fact that the holding costs do relate to the taxable gain on sale” and are incurred in
deriving assessable income. It contravenes the general permission and taxes
homeowners on an amount greater than the net gain.

79 Part VI(A) of this article will show that the courts favour apportionment over this literal
interpretation.
81 Sections 1 and 21.
82 Section 222.
83 Section 38.
84 Bowden (Inspector of Taxes) v Russell & Russell [1965] 1 WLR 711 (Ch). However, in practice Her
Majesty’s Revenue and Customs, which is United Kingdom’s tax collection government
department equivalent to New Zealand’s Inland Revenue, often allows apportionment between
dual purposes to produce allowable and non-allowable portions of expenditure. Courts have
suggested that “wholly and exclusively” should not be read too literally to produce
unreasonable results. See Inland Revenue Commissioners v Richards’ Executors [1971] 1 WLR
571 (HL) at 574 and 583.
85 Taxation of Chargeable Gains Act (UK), s 39(1).
86 Section 39(2).
87 Section 39(2).
88 Inland Revenue, above n 2, at [2.13].
It is particularly unfair for those who regularly purchase properties to renovate and sell, and live in the properties while they own them. They would be taxed on all the properties’ gains (due to their regular pattern of buying and selling), but would be denied deductions for all holding costs, including repairs and maintenance expenditure.

Furthermore, as discussed below, denying deductions is incongruent with established deductibility rules, undermining horizontal equity.

(1) Holding costs are deductible where land is purchased with intention to sell

Tax treatment should be consistent for all revenue account property, regardless of whether the property is held on revenue account by virtue of the bright-line test (s CB 6A), one of the 10 year rules (ss CB 9 to CB 11) or by the purpose and intention test (s CB 6). Consider the situation where Kate and Liam each purchase a property, allowing their respective parents to live in it rent-free, then sell it four years later. The Commissioner establishes that Kate had acquired it with a purpose or intention of disposal and the sale proceeds are taxed under s CB 6.89 This means she can deduct not only the purchase cost and capital improvements, but also revenue expenditures such as holding costs.90 However, suppose the Commissioner could not adduce evidence that Liam bought his property with an intention to dispose, meaning his sale proceeds are taxed under the s CB 6A bright-line test.

Under Interpretation Two, Liam would be denied deductions for his holding costs. This undermines horizontal equity. The two taxpayers faced similar situations and cash flows and thus deserve similar tax treatment. This is especially because the bright-line test was designed as a proxy for the intention test.91 The true targets of both tests are short-term property speculators—people like Kate who buy with a subjective intention to resell.92 People like Liam might not even have such an intention but are unfortunately caught by the objective contours of the bright-line test. It would be harsh for Liam to be taxed more than Kate.

(2) Capital improvements are deductible even if for private enjoyment

Section DB 23 states that a deduction is allowed for “the cost of revenue account property”, and it is settled that this includes capital improvements made after acquisition.93 This is regardless of whether they were private in nature. So, if Max installs a swimming pool in the backyard of his private bach for his personal enjoyment, he is entitled to deduct its entire cost in computing his taxable gain. It is irrelevant whether the pool enhanced potential sale proceeds. Meanwhile, suppose Nina expends substantial amounts repairing a retaining wall that supports her private bach situated on a steep hillside. The works did not amount to a reconstruction and are thus revenue in nature and not deductible. This seems inequitable, particularly when the repairs were arguably more

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89 Although the test is subjective, intention is assessed against evidence such as communications and steps taken before and after acquiring the land, the length of time it is held, and whether the person has a pattern of acquiring and disposing land. See Commissioner of Inland Revenue v Boanas (2008) 23 NZTC 22,046 (HC) at [70]–[73].

90 Inland Revenue Income Tax – Land Acquired for a Purpose or with an Intention of Disposal (QB 16/06, 28 July 2016) at [32]–[33].

91 Inland Revenue, above n 16, at 1.

92 At [13]–[17].

93 McClay, above n 38, at 20; and Inland Revenue, above n 1, at 88.
critical to preserving the property’s value and had a closer nexus to the assessable income than Max’s pool.

(3) Implementation issues

Aside from the unfairness inherent in denying deductions, there are also concerns over the IRD’s proposal to “[base] deductibility on the current year use of the land”.\(^94\) If the use in the current year is income-earning, such as for rental purposes, deductions for holding costs would be allowed; however, if the use in the current year is private, deductions would be denied.\(^95\) This appears arbitrary and open to gaming. If a taxpayer lives in a property for four years then rents it out and sells it in the fifth year, all holding costs for the duration of the ownership period would be deductible even though the land was used privately for most of the time.

E Summary

Denying all deductions for holding costs for private use periods is the interpretation most consistent with a strict reading of the legislation. However, it seems unfair as it neglects the fact the costs relate to the assessable income, subjecting homeowners to taxation on more than their true gain.

VI Interpretation Three: Apportion Between Gain and Private Benefit

The third interpretation of the law is that holding costs should be apportioned between the value of private use benefits (non-deductible portion) and the gain on sale (deductible portion). For example, if a person received $10,000 worth of private benefits from their private use of land, and a $10,000 gain on sale, they would be entitled to deduct 50 per cent of the holding costs on the basis that only 50 per cent of the total benefit is taxable.

A Apportionment is the most principled approach

For simplicity, we first consider the case where the property taxable on sale is solely used privately (rather than sometimes privately and sometimes to earn rent), thus considering apportionment between the private benefit and the gain (rather than between the private benefit, the rental income and the gain).\(^96\)

The concept of apportionment is grounded in the fact that an expenditure is allowed as a deduction “to the extent” that it is incurred in deriving assessable income, and not allowed “to the extent” that a general limitation applies.\(^97\) In *Buckley & Young Ltd v Commissioner of Inland Revenue*, the Court stated “[t]he purpose of an apportionment is to ascertain how much of the sum actually expended is attributable to the deductible item.”\(^98\) It may be based on an asset’s factual use or availability for use for each of the two times.

\(^94\) Inland Revenue, above n 2, at [2.10].
\(^95\) At [2.10].
\(^96\) This engages the mixed-use assets rules which will be discussed in Part VI(D) of this article.
\(^97\) *Buckley & Young Ltd v Commissioner of Inland Revenue*, above n 7, at 488.
\(^98\) At 497.
purposes, or on a pro rata basis by reference to the advantages generated by the expenditure, or on any other reasonable basis for apportionment.\textsuperscript{99}

Several cases have apportioned expenses between a private, non-deductible portion and an income-earning, deductible portion. These cases were decided under the Income Tax Act 1976. However, there are no material differences between the two Income Tax Acts for our purposes. Interestingly, a literal reading of the 1976 Act, like s DA 2(7) of the 2007 Act, also suggests that the private limitation overrides the general permission.\textsuperscript{100} Nevertheless, apportionment was still considered appropriate by the courts.

In \textit{Case F30}, the taxpayer was a private company in the business of selling swimming pool accessories and water treatment products.\textsuperscript{101} The company did not have a swimming pool they could use to test new treatment products and so built a pool at the home of its major shareholder.\textsuperscript{102} The company paid for the pool and claimed a deduction for its full cost. As a preliminary matter, the Authority held that it was a revenue, not capital, expenditure.\textsuperscript{103} The pool was not a company asset, and was more related to its day-to-day operations than to its structure.\textsuperscript{104} Also, it was clearly incurred in producing assessable income: the pool was regularly used for the testing and demonstrations of company products, and its benefit is evidenced by the dramatic growth in revenues from the time the pool was constructed.\textsuperscript{105}

The second question is whether any part of the expenditure was of a private or domestic nature. The Authority held the pool had a dual character.\textsuperscript{106} It was used for business purposes but also conferred a private benefit to the shareholder. The pool improved the property and the major shareholder and his family used it in a normal domestic manner. Expenditure by a company can be of a private character (wholly or partly) where an individual beneficiary derives a private benefit from the expenditure.\textsuperscript{107} This is the case even though the private use was necessary to the pool’s effective commercial use (testing and client demonstrations were most effective when conducted in practical residential conditions, with rainfall, overhanging trees and the like). The Authority stated the company and the shareholder benefitted equally from the pool and apportioned its cost between the business and private character to allow a deduction of 50 per cent.\textsuperscript{108}

\textit{Commissioner of Inland Revenue v Eales} provides another illustration of apportionment.\textsuperscript{109} The taxpayer carried on a horse training business which received income from horse owners. He was entitled to a share of the prize money for some of the

\begin{itemize}
\item \textsuperscript{99} At 497–498.
\item \textsuperscript{100} Section 104 of the Income Tax Act 1976 stated “any expenditure or loss to the extent to which it ... [i]s incurred in gaining or producing the assessable income ... may, except as otherwise provided in this Act, be deducted” (emphasis added). Section 106 states “Notwithstanding anything in section 104 ... no deduction shall ... be made in respect of ... [a]ny expenditure or loss to the extent to which it is of a private or domestic nature” (emphasis added).
\item \textsuperscript{101} \textit{Case F30}(1983) 6 NZTC 59,704 (TRA).
\item \textsuperscript{102} At 59,704.
\item \textsuperscript{103} At 59,711.
\item \textsuperscript{104} At 59,709–59,710.
\item \textsuperscript{105} At 59,710.
\item \textsuperscript{106} At 59,711.
\item \textsuperscript{107} See also \textit{Case E87} (1982) 5 NZTC 59,455 (TRA), where it was held that a company incurred expenditure of a private or domestic nature in paying for the cost of a heart operation on a key employee.
\item \textsuperscript{108} \textit{Case F30}, above n 101, at 59,711.
\item \textsuperscript{109} \textit{Commissioner of Inland Revenue v Eales} (1987) 9 NZTC 6,203 (HC).
\end{itemize}
racehorses under his care even though he did not own them. He claimed a deduction for variable costs (stock food, veterinary charges) and non-variable costs (rent, accounting fees) against business income. The taxpayer conceded that the variable costs contained a private element because they included expenditure for horses in which he had a share, and therefore were not fully deductible. In dispute was whether the non-variable costs also contained a private element. The Court held that once it is accepted that the variable costs had a private element, that must be extended to apply to the non-variable costs. The total expenditure, whether fixed or variable, was partly incurred in connection with the business, but also partly in connection with private purposes. As a result, the costs were apportioned and deductible only in part.

These cases, and various others, show that apportionment is consistent with legislation and is a principled approach to the deductibility of holding costs. Indeed, the IRD acknowledges that “apportioning holding cost between private and taxable benefits would be the most accurate approach”.

B Would apportionment be too complex?

The reason the IRD prefers a blanket denial of deductions instead of apportionment is because apportionment, in their view, would be too complex:

[C]orrect apportionment requires both the benefit of the current year use, and the income derived on sale, to be measurable. Measuring the value of the private benefit is likely to be difficult, and the taxable gains are not known until the property is sold. Therefore, accurate apportionment is likely to be complex.

However, measuring the value of the private benefit is not necessarily difficult—it can be based on an estimation of the property’s market rental during the period of private use. The council rating value can be used as the default market rental. Taxpayers can rebut this with their own valuation, supported by various online valuation tools which use inputs such as the property’s location, the type of dwelling, the number of bedrooms and its quality. The onus of proving the reasonableness of the estimation should rest on the taxpayer. Neither is it an issue that the taxable gains are not known until the property is sold. This is because tax liability only arises on the sale of the property when the gains are quantifiable.

110 At 6,203.
111 Section 61(31) of the Income Tax Act 1976 stated that horse race prize money is exempt from income tax.
112 Commissioner of Inland Revenue v Eales, above n 109, at 6,208.
113 At 6,208.
114 For example, Case E53 (1983) 5 NZTC 59,307 (TRA). Interest paid on a loan partly to acquire a family residence and partly to finance the retention of a rental property was deductible to the extent the funds were used to retain the income producing property. The balance is of a private nature and not deductible.
115 Inland Revenue, above n 2, at [2.5].
116 At [2.5].
117 For example, see the online calculators of New Zealand Property Investors Federation Making the right investment: With the right help & support <www.nzpif.org.nz>; and Tenancy Services Market rent <www.tenancy.govt.nz>, which sources market rent data from bonds lodged.
C. How apportionment might work where property is solely used privately

Although these factors pose no barriers to apportionment, laying out precisely how apportionment might work reveals hidden complexities that may undermine its feasibility.

Suppose Owen purchases a $600,000 apartment for his twin daughters to live in while they attend university. Although market rent would have been $25,000 per year, his daughters live there for free (the property is used privately and not to earn income). Four years later, they graduate and Owen sells the apartment for $800,000. This transaction is taxable under the bright-line test. Over the 4 years, he incurred $45,000 in holding costs on the apartment, comprised primarily of interest. These may be apportioned as follows:

Gain on sale = Proceeds from sale – Purchase cost
= $800,000 – $600,000
= $200,000

Private benefit = Market rent during private use
= $25,000 × 4 years
= $100,000

Total benefit = $200,000 + $100,000
= $300,000

Proportion of holding costs deductible = Gain on sale / Total benefit
= $200,000 / $300,000
= 2 / 3

Amount of holding costs deductible = 2 / 3 × $45,000
= $30,000

The above calculations apportion the holding costs between the value of the gross gain and the value of the private benefit. The gain was 2/3 of the total benefit, so 2/3 of the holding costs ($30,000) are deductible. Thus, apportionment is relatively straightforward where the property is solely used privately.

D. How apportionment might work where property is sometimes used privately and sometimes income-earning

If a property is sometimes used privately and sometimes rented out, determining the extent of deductibility for holding costs should involve a two-step process:

1) Use the “mixed-use asset” rules in subpart DG to determine what is deductible against the rental income.

2) Then, apportion the rest of the holding costs to determine what is deductible against the capital gain.

Consider the following example. Paige buys a bach on Waiheke Island for $1 million. Every year, she rents it out for nine months and reserves three months for private use. The market rent is $40,000 per year. Four years later, she sells the bach for $1.2 million, which is taxable under the bright-line test. Over the four years, she incurred $60,000 on general holding costs such as interest and maintenance, and $5,000 on advertising and repairing damage caused by tenants.
Deductibility of Holding Costs for Privately Used Land Taxable on Sale

(1) Step one: apply mixed-use asset rules to calculate what is deductible against rental income

Subpart DG sets out the mixed-use asset rules, which apply to land, ships and aircraft used both for deriving income (such as rent) and for private use. Section DG 9(2) provides a formula to apportion expenditure between its income-earning use and its private use:

\[
\text{Apportionment formula} = \frac{\text{expenditure} \times \text{income-earning days}}{\text{income-earning days} + \text{counted days}}
\]

As a preliminary matter, expenditure that relates solely to the income-earning use is not subject to apportionment.\(^{118}\) Thus, the $5,000 incurred on advertising and repairing damage explicitly caused by tenants is fully deductible against Paige’s rental income.

For the $60,000 general holding costs, the formula determines the amount deductible against the rent:

\[
\text{Amount deductible} = \$60,000 \times \frac{9}{9+3} = \$45,000 \text{ (over 4 years)}
\]

This is the \(\frac{9}{12}\) portion attributable to the property’s income-earning use.

General holding costs not yet deducted = $60,000 – $45,000

= $15,000

(2) Step two: apportion the rest of the holding costs ($15,000) to calculate what is deductible against the gain

This follows the process used in Owen’s case. It apportions the holding costs relating to the period of Paige’s private use (the $15,000) between the value of the private benefit and the value of the gain. This calculates the amount deductible against the gain.

\[
\begin{align*}
\text{Gain on sale} & = \text{Proceeds from sale} - \text{Purchase cost} \\
& = \$1.2 \text{ million} - \$1 \text{ million} \\
& = \$200,000 \\
\text{Private benefit} & = \text{Market rent} \\
& = \$40,000 \times \frac{3}{12} \times 4 \text{ years} \\
& = \$40,000 \\
\text{Total benefit} & = \$200,000 + \$40,000 \\
& = \$240,000 \\
\text{Proportion of holding costs deductible (against gain)} & = \frac{\text{Gain on sale}}{\text{Total benefit}} \\
& = \frac{\$200,000}{\$240,000} = \frac{5}{6} \\
\text{Amount of holding costs deductible (against gain)} & = \frac{5}{6} \times 15,000 \\
& = \$12,500
\end{align*}
\]

Therefore, regarding the sale of the bach, Paige will be taxed on $200,000 less $12,500 less any deductible incidental costs.

\(^{118}\) Income Tax Act, s DG 4(4).
The two-step process ensures that expenditure that is allowed a deduction against rental income is not available for deduction against the gain on the sale of the land—it prevents double deduction.

Under this process, the well-established mixed-use asset rule continues to operate in the ordinary way to determine deductibility against rent (step one). Of the $60,000 holding costs, even though $45,000 has already been deducted against the rent (step one), it still makes sense to allow some of the residual $15,000 to be deducted against the capital gain (step two). Without step two, we are back at Interpretation Two where deductions are completely denied for periods where land is used privately. The remaining $15,000 of holding costs is partly deductible because it was partly used to derive assessable income in the form of a capital gain.

E How to treat periods of vacancy

So far, apportionment appears to be a feasible option, but complexities arise when considering the issue of how to treat periods of vacancy. When should vacant periods be treated as private use and when should they be considered income-earning?

This question matters if deductions are fully denied for periods of private use (Interpretation Two) or partly denied for periods of private use (Interpretation Three).

(1) IRD’s suggestion

The IRD proposes treating vacant time as “either private or income-earning [based] on the other uses of land during the period of ownership”.\(^{119}\) If land is otherwise actively used privately or to earn income, vacant days should be treated similarly. For example, if a rental property was vacant for a few months between tenants, vacant time would be treated as income-earning.

If land is used privately and to earn income, vacant days should be apportioned based on the proportion of actual private and income-earning days. So, if a bach is used privately for two months a year and rented out for four months a year, 33 per cent of vacant days are treated as private days and 66 per cent are treated as income-earning days.

(2) Evaluation

The IRD’s suggestion is intuitive and consistent with existing mixed-use asset apportionment rules. However, for the purposes of determining deductions for privately used land taxable on sale, it is vulnerable to gaming by taxpayers.

For example, Ron is selling his bach and wants to minimise the taxable gain by maximising deductible holding costs. Each year, he rents it out for three months and uses it personally for three months. 50 per cent of days would be treated as income-earning and 50 per cent of holding costs would be deductible. However, Ron would be incentivised to say that he only used the bach himself for one month. Then, 75 per cent of days would be treated as income-earning and 75 per cent of holding costs would be deductible. It would be difficult for the IRD to police or prove the actual extent of private use.

A potential solution is to base the number of income-earning days on the days the property was actually advertised for rent. However, loopholes remain. A property might be advertised for rent but not genuinely available for rent. Ron might “advertise” it in a

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\(^{119}\) Inland Revenue, above n 2, at [3.2].
way that limits its exposure to potential tenants, such as on a low traffic website or a restricted social media group. He might impose unreasonable or stringent conditions to reduce its likelihood of actually being rented, such as setting the rent above market rates or demanding extensive references. It would be difficult to draw a line on when properties are genuinely available for rent and to monitor this.

Another potential solution is to treat all vacant days as private if land was used both privately and to earn rent. But this frustrates the entire purpose of apportionment, which is to split expenditure into a deductible and non-deductible element on a proportionate basis. It undermines all the above calculations for Paige, which implicitly allocated vacant days in a proportionate way.

F Summary

Apportioning holding costs between the value of the private benefit and the value of the gross gain is consistent with the words of the legislation as interpreted by the courts. For properties that are solely used privately, it is a principled approach that can be neatly applied. However, for properties that are used both privately and to generate rent at different times, complexities arise on the treatment of vacant days. An apportionment solution immune to gaming by taxpayers may undermine the accuracy that made apportionment attractive in the first place.

VII Synthesis and Conclusion

A Issue

This article posed the question of whether, and to what extent, holding costs are deductible where they relate to land that is privately used but taxable on sale. This issue has gained particular relevance since the introduction of the bright-line test, which has brought more privately used land into the tax base, but also arises in relation to land taxed under other provisions.

This article offered three interpretations of the law: holding costs are fully deductible for periods of private use; holding costs are not deductible for periods of private use; or holding costs are partly deductible for periods of private use, based on an apportionment between the gain on sale and the value of the private benefit. All are permissible readings of the existing law. The analysis is an attempt at clarification rather than advocating for reform.

B Evaluation

There are three themes or criteria that may assist in selecting the best interpretation:

- consistency with the wording of the legislation;
- fairness and equity for taxpayers; and
- simplicity and practicality.
The following table displays the extent to which each interpretation satisfies the criteria:

<table>
<thead>
<tr>
<th>Options</th>
<th>Consistency with words of legislation</th>
<th>Fairness and equity</th>
<th>Simplicity and practicality</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Allow all deductions</td>
<td>![Icon]</td>
<td>![Icon]</td>
<td>![Icon]</td>
</tr>
<tr>
<td>2. Deny all deductions</td>
<td>![Icon]</td>
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<td>![Icon]</td>
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<tr>
<td>3. Apportion</td>
<td>![Icon]</td>
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</table>

(1) Consistency with the words of the legislation

Allowing deductions in full requires a strained reading of the legislation. While there is a sufficient nexus between the holding costs and the gain, such that they are incurred in deriving assessable income, the general permission is expressly subject to the private limitation. Although *Pacific Rendezvous Ltd* stated funds are fully deductible as long as they were employed in deriving assessable income regardless of any parallel capital purpose, here, the private enjoyment feels more like a competing purpose than a parallel one.

There is a good case that the words demand denying all deductions. Section DA 2(7) states the private limitation does not merely support, but “overrides” the general permission. This suggests that if a dollar has some private or domestic nature, it is strictly non-deductible, even if it produces assessable income.

However, case law has not followed this literal interpretation. Where expenditure satisfying the general permission also conferred a private benefit, courts have apportioned it to a private, non-deductible portion and an income-producing, deductible portion. This reflects the essence of the words “to the extent” in the provisions. Therefore, apportionment is most consistent with the words of the legislation as interpreted by the courts.

(2) Fairness and equity

Denying all deductions for holding costs is unfair. It does not recognise that they relate, at least in part, to the gain on sale, and effectively taxes homeowners beyond their actual net gain. It is also inequitable because it denies bright-line taxpayers deductions for all holding costs, while allowing such deductions for taxpayers who purchased land with an intention to resell, even if they used the land privately.

On the other hand, allowing full deductions for appropriate holding costs is a fair approach. After all, many holding costs are not incidental to, but have a direct nexus with, the taxable gain. Repairs and maintenance are often undertaken with the primary purpose of preserving the value of the property, and interest costs are often endured in the anticipation of the property gaining value over time. From a fairness perspective, all that
should matter is whether the expenditure was incurred in deriving assessable income. The fact an expenditure is private is merely a factor suggesting it does not have a sufficient nexus with the income. But if the nexus exists, the deduction should be allowed.

Apportionment is also a fair approach. The taxpayer undoubtedly receives a private benefit from the asset. What is deductible should reflect the value of the gain (the assessable income) as a proportion of the value of the total benefit including the private benefit. This is also equitable as it is consistent with how courts treat like cases.

(3) Simplicity and practicality

So far, based on the first two criteria, apportionment appears to be preferred because it is both a fair and a natural interpretation of the law. However, it requires resolving the question of how to treat vacant periods. Allocating vacant days as private or income-earning based on the proportion of actual private and income-earning days will incentivise misreporting by taxpayers. However, a model that guards against gaming, such as treating all vacant days as private, undermines the essence of apportionment.

In contrast, allowing all deductions is much simpler to understand and practical to enforce. This is particularly important as the relevant taxpayers tend to be everyday individuals—mums and dads—not sophisticated commercial entities.

C Conclusion

Evaluated against these criteria, the most favourable approach would be either allowing full deductions, or partial deductions. Ultimately, it comes down to the relative value placed on the simplicity of the tax system versus consistency with like cases. In the absence of a workable and accurate method of apportionment, it is suggested that holding costs should be fully deductible. Regardless, owners of privately held land taxable on sale should challenge the IRD’s steadfast approach of denying these deductions so that the question can be judicially considered.