

QUESTIONS WE'VE BEEN ASKED | PĀTAI KUA UIA MAI

# Income tax – deductibility of expenditure – renting to flatmates

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QB 23/08

This Question We've Been Asked explains when a person can claim deductions for expenditure incurred in deriving rental income, where the person rents a room in their home to a flatmate. It considers the possible application of the interest limitation, residential ring-fencing and mixed-use asset rules.

## Key provisions | Whakaratonga tāpua

Income Tax Act 2007 – ss DA 1, DA 2, YA, CC 1, DG 3, DH 5, EE 50, EL 4, EL 9, s YA 1 (“main home”), Schedule 15

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## Question | Pātai

**If a home owner lives in their home and rents out a room to a flatmate, can they claim deductions for costs incurred in deriving the rental income?**

## Answer | Whakautu

**Yes. A home owner can claim deductions for costs incurred to the extent the expenditure is incurred in earning the rental income from the flatmate(s). The rental income from the flatmate is taxable.**

**Any expenditure incurred in earning the income from the flatmate needs to be apportioned between private use (living in the house) and income-earning use (rental income from a flatmate). Apportionment based on the use of physical space is a reasonable basis on which to determine the income-earning component of expenditure and to calculate the deduction amount.**

**There are some specific rules that may impact the home owner's tax treatment but these generally do not apply in flatmate situations:**

- The interest limitation rule will not apply if the land is used predominantly for the person's main home.
- The residential ring-fencing rule will not apply if more than 50% of the land is used for most of the income year by the person as their main home.
- The mixed-use asset rules will not apply because the home is unlikely to be left vacant for the period required under the rules. If the mixed-use asset criteria are satisfied, the exclusion for long-term rental property is likely to apply.

**Generally, the fact a person rents out a room in their home to a flatmate while living in the home will not stop the home being the person's main home.**

## Explanation | Whakamāramatanga

### Introduction

1. This Question We've Been Asked (QWBA) explains how a person (the owner) who rents out a room in their home to a flatmate calculates their deductions for costs incurred in deriving the rental income.

2. We have been asked to consider:
  - how to calculate the amount of expenditure incurred in deriving income from renting out a room to a flatmate;
  - whether a home is an owner's "main home" if the owner shares their home with one or more flatmates;
  - whether the interest limitation rules apply to deny deductions for interest expenditure;
  - whether the residential ring-fencing rules apply to a person renting out a room to a flatmate; and
  - whether the mixed-use asset rules apply.
3. This item assumes the:
  - rental activities do not constitute the carrying on of a business;
  - person renting out the room is the property owner;
  - land has an existing single dwelling constructed on it;
  - land is not new build land within the scope of the s DH 4 exemption to the interest limitation rules;
  - property is the person's only home; and
  - flatmate is a third party and not a guest or family member who pays below market rent.
4. Private boarders and home-stay students are different to flatmates. Boarders pay for accommodation and services (eg regular meals). To remove any doubt, our discussion on the deductibility of costs at [6] to [19] does not apply to people who apply [DET 19/01: Standard-cost household service for private boarding service providers](#) (Determination, Wellington, Inland Revenue, May 2019) or [DET 19/02: Standard-cost household service for short-stay accommodation providers](#) (Determination, Wellington, Inland Revenue, May 2019).
5. All legislative references are to the Income Tax Act 2007 unless otherwise stated.

## **Deductibility of costs incurred in renting a room to a flatmate**

6. When renting a room to a flatmate, an owner will incur costs that relate to earning the rental income. Common types of costs include:

- insurance;
  - local authority rates (including water rates);
  - electricity, gas, internet and other utilities;
  - repairs and maintenance; and
  - interest.
7. The owner is allowed to claim a deduction for expenditure to the extent it is incurred in deriving assessable income from renting a room to a flatmate. A deduction will be available only for periods where the owner has rented a room to a flatmate and not if the room is merely available for use. If the room is not rented out it will be for the owner's private use.
  8. Rent that the owner receives from their flatmate is assessable income (s CC 1).
  9. It is a question of fact whether a sufficient relationship exists between the expenditure and the derivation of income. It requires ascertaining the true character of the expenditure and considering the relationship between the advantage sought or obtained from the expenditure and the owner's income.
  10. Generally, where an owner rents a room to a flatmate, a sufficient relationship between the rental income and above types of expenditure will exist and the issue is one of apportionment.

### **Basis of apportionment**

11. A deduction is allowed to the extent to which expenditure is incurred in deriving assessable income.<sup>1</sup> However, a deduction is denied to the extent the expenditure is of a private or domestic nature (this is known as the private limitation).
12. The owner needs to apportion any mixed-use expenditure between their private use of the property and the rental use of the property.
13. For the period the owner is renting a room in their home to a flatmate, the use of the physical space is a reasonable basis for apportionment of mixed-use expenses. The owner's home will typically involve three types of space:
  - the owner's private or exclusive use area;

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<sup>1</sup> The deduction amount may be limited to the amount of income derived where a flatmate pays less than a market value rent (*Case E54* (1982) 5 NZTC 59,312 (TRA)). However, these situations are outside the scope of this QWBA.

- the flatmate's exclusive use area; and
  - common or shared areas.
14. An area will be for the flatmate's exclusive use only if it is specifically agreed by the parties that it is for the flatmate's exclusive use.
15. In the apportionment calculation, expenses wholly relating to:
- the flatmate's exclusive use area should be treated as 100% deductible.
  - the owner's private use area should be treated as 0% deductible.
16. In addition, the Commissioner is satisfied that common use areas may be treated as 50% deductible.<sup>2</sup> Example | Taura 1 at [53] illustrates how to apportion expenditure based on physical space.
17. Mixed-use expenditure must be apportioned. But it may be possible to identify some items of expenditure (for example, specific repairs and maintenance expenses relating to a flatmate's room) as directly referable to the production of assessable income and not subject to apportionment under the private limitation. In these cases, the full amount may be deducted as expenditure incurred in deriving assessable income. On the other hand, there may be occasions where the expenditure is incurred solely for private use, so is non-deductible.

## Depreciation loss

18. A depreciation loss is not available for residential buildings (that is, the home). However, the owner may be able to claim depreciation on chattels used or available for use in deriving assessable income.
19. If the owner has a depreciation loss in an income year, a deduction is allowed to the extent the loss is incurred by the owner in renting the room to the flatmate.
20. If the chattels are exclusively used by the flatmate, the owner can claim a deduction for the full depreciation loss. See the treatment of curtains in Example | Taura 2. On the other hand, the owner cannot claim a depreciation loss if the chattels are for their exclusive use.

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<sup>2</sup> The Commissioner has generally accepted 50% as a reasonable apportionment for common use areas (see [QB 19/05: What are my income tax obligations if I rent out my home or a separate dwelling on my property as short-stay accommodation](#) (Question We've Been Asked, Wellington, Inland Revenue, May 2019) and [Interpretation statement IS 17/02: Deductibility of Farmhouse Expenses](#) (Wellington, Inland Revenue March 2017)).

21. The owner may claim for only part of the depreciation on mixed-use chattels (that is, chattels in common areas that both the owner and flatmates can use).
22. The approach to work out how much depreciation the owner may claim each year for mixed-use chattels is similar to the approach to apportioning mixed expenses. The first step is to work out the depreciation loss for the year for each asset.
23. For low value items (up to \$1,000), the depreciation loss is the asset's cost. If the asset is part of a group of items purchased at the same time from the same supplier, and the items would have the same depreciation rate, the \$1,000 threshold applies to the group of items.
24. For other assets, the depreciation loss for the year is worked out using either the diminishing value (DV) method or the straight-line (SL) method. For information about the methods and the depreciation rates, see our website: [Depreciation rate finder and calculator](#).
25. Once the depreciation losses for the year are calculated for the mixed-use chattels (including for low value items<sup>3</sup>) in the owner's home, the next step is to work out what proportion of those losses may be deducted.
26. Generally, the amount of the depreciation loss on chattels in common areas should be apportioned so that 50% is treated as relating to private use and non-deductible. However, where the actual use of the asset can be clearly demonstrated, an alternative basis may be adopted if it reflects a reasonable basis for apportionment.

## Interest limitation rules

27. The interest limitation rules operate to deny interest deductions claimed by residential property owners. The interest limitation rules contain, among other exclusions and exceptions, a form of main home exclusion and an exception for new builds.<sup>4</sup>
28. The interest limitation rules deny the owner a deduction for interest incurred in relation to their land unless the land is "excepted residential land" as described in Schedule 15. Schedule 15 contains a main home exclusion.
29. The interest limitation rule does not apply to land used predominantly for a place configured as a residence or abode if that place is the person's main home.

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<sup>3</sup> When determining whether an asset is a low value item, the asset's cost must be equal to or less than \$1,000 prior to any apportionment for private use.

<sup>4</sup> For the purpose of this item, we have assumed the land is not new build land within the scope of the s DH 4 exemption.

30. Whether an owner who rents out a room in their home to a flatmate is denied deductions for interest due to the interest limitation rules depends on the facts of each situation, namely:
- whether the land is used predominantly for a place configured as a residence; and
  - whether the place is the owner’s main home.

### “Used predominantly for a place configured as a residence”

31. Whether a place is “configured as a residence” depends on whether the place has been formed or shaped to function as a place of residence, irrespective of whether it is currently used as a place of residence. A “residence” means a place where a person has a fixed presence and a degree of permanence. Therefore, a place will be configured as a residence if it is capable of being used as a residence with a degree of permanence.
32. Land will have been used predominantly for a place configured as a residence where the physical area of the land used for the place is more than 50% of the total land area.
33. If the land is used for one place configured as a residence, the “used predominantly” threshold will be satisfied. If other dwellings are situated on the land or the land is used for other purposes, the physical space of the respective structures or uses needs to be determined.<sup>5</sup> This QWBA deals only with land that has a single existing dwelling situated on it.

### Main home

34. The next step is to consider whether the place is the owner’s main home. “Main home” is defined in s YA 1 as:

**main home** means, for a person, the 1 dwelling—

- (a) that is used as a residence by the person (a **home**); and
- (b) with which the person has the greatest connection, if they have more than 1 home

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<sup>5</sup> See Example 9: Multiple residences on a single legal title in [Special report on interest limitation and additional bright-line rules](#) (Wellington, Inland Revenue, March 2022).

35. The definition provides that for a person the main home is the one dwelling they use as a residence. The focus of the main home definition is on the nature of the place and the relationship between the person and that place.
36. A “residence” is the place where a person has settled, where they ordinarily eat, live and sleep, and the place the person uses as a base for their daily activities and is the seat of that person’s domestic life and interests. “Used” means actual physical use of the dwelling and not intended use. Therefore, a dwelling is used as a residence when it is customarily or repeatedly used for this purpose.
37. The definition of main home does not contain any restrictions that precludes a dwelling being the owner’s main home due to the presence of a flatmate.
38. Generally, if the owner lives in the home and rents out a room to a flatmate(s), the owner still uses the dwelling as their residence.
39. Where considerable areas of the dwelling are for the flatmate’s or flatmates’ exclusive use, it might be argued that the owner does not reside in the entire dwelling. However, the definition does not require that the owner has full use and enjoyment of the dwelling nor does it use any language of apportionment. For that reason, if the dwelling is used as the owner’s residence it will be within the scope of the main home exclusion and not subject to the interest limitation rules.

## Residential ring-fencing rules

40. The residential ring-fencing rules prevent the owner from offsetting deductions incurred for residential properties against other sources of income (for example, salary or wages). This means if the rental activity is loss-making (the deductible expenses exceed the income), the excess deductions cannot be claimed that year. Any excess deductions are not permanently forfeited but are carried forward and may be offset against any future income derived from the residential property.
41. The residential ring-fencing rules apply to residential land where the person who owns the land is allowed a deduction for expenditure relating to its use or disposal. “Residential land” includes land that has a dwelling on it unless the land is farmland or used predominantly as business premises.
42. There are a few exclusions to the residential ring-fencing rules, including a main home exclusion.



## Main home exclusion

43. The main home exclusion from the residential ring-fencing rules differs from the main home exclusion from the interest limitation rules. The owner can apply the main home exclusion if more than 50% of the land is used as the owner's main home for most of the income year. Therefore, the main home exclusion will apply if:
- more than 50% of the land is used as the owner's main home (the space threshold); and
  - the land is used as the owner's main home for more than 50% of the income year (the time threshold).
44. The definition of a main home was discussed at [34].
45. As referred to above, where an owner rents out a room in their home to a flatmate, the three typical types of space are:
- the owner's private or exclusive use area;
  - the flatmate's exclusive use area; and
  - common or shared areas.
46. The common use area is used by the owner as part of their residence. The fact the flatmate has access to the common use areas does not limit the owner's ability to use the area as their residence. Therefore, the owner's main home space consists of the owner's private use area and the common use areas (without apportionment for the flatmate's use). The area that is for the flatmate's exclusive use is excluded from the space threshold calculation.
47. It is likely an owner will be able to satisfy the space threshold if the land contains a single dwelling.
48. The time threshold will be satisfied if the land is the person's main home for more than 183 days in an income year. Whether the time threshold has been satisfied depends on the specific facts of each situation.
49. As sharing a home with flatmates does not prevent the home being the owner's main home, if both the space threshold and time threshold are satisfied, the main home exclusion to the residential ring-fencing rules will apply.

## Mixed-use asset rules

50. The mixed-use asset rules apply where assets are sometimes used privately, sometimes used to earn income, and are unused for a significant period during the year. The rules

ensure an appropriate proportion of the expenses that relate to the “unused” period is deductible. The proportion that is deductible is based on the amount of income-earning use relative to the total use of the asset.

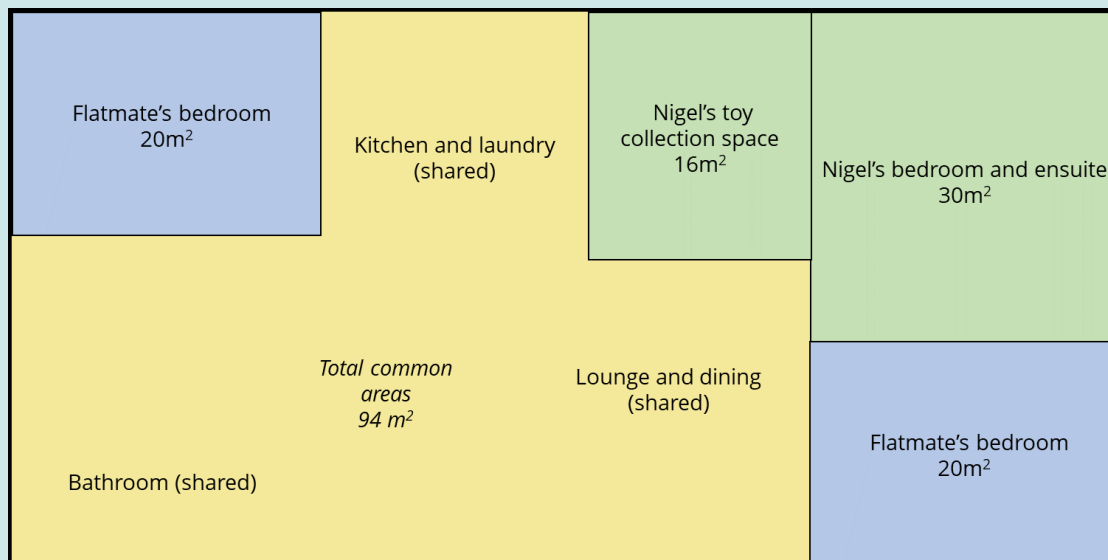
51. The mixed-use asset rules are unlikely to be relevant to an owner who rents out a room to a flatmate as the home is not unoccupied for at least 62 days during the income year.
52. If the mixed-use asset criteria are satisfied, it is likely that the specific exclusion for long-term rental property (s DG 3(4)(b)) will apply. Regardless of the mixed-use asset rules, a home owner will be unable to claim a deduction for expenditure incurred for any periods where the home is vacant.

## Examples | Taurira

53. The following two examples illustrate how the law applies.

### Example | Taurira 1 – Person rents out unfurnished rooms to two flatmates

Nigel lives in his three bedroom home with two flatmates. He purchased the home on 5 March 2022 and started renting out the two spare bedrooms to flatmates on 1 April 2022. The home has a 180m<sup>2</sup> floor plan as shown in the diagram below.



Nigel charges each flatmate \$220 per week (a total of \$22,880 in the 2023 income year). Nigel also receives a salary of \$62,400.

In the income year, Nigel incurred the following expenses (total \$44,900) relating to the property:

- interest – \$37,000
- local authority rates – \$2,500
- house insurance – \$2,600
- utilities (power, gas, internet) – \$2,800.

Nigel has elected not to depreciate any chattels. He should apportion his mixed expenses on the following basis:

- 40m<sup>2</sup> used exclusively by flatmates – 100% deductible
- 94m<sup>2</sup> common or shared areas – 50% deductible
- 46m<sup>2</sup> private area – 0% deductible.

Nigel must calculate what proportion of his mixed-use expenses he may deduct for the areas of the house used exclusively by the flatmates and what proportion he may deduct for common areas. The results of those calculations are then added together.

$$40/180 \times 100 = 22.22\%$$

$$94/180 \times 50 = 26.11\%$$

By adding the two figures (22.22% and 26.11%), Nigel calculates that, subject to any specific limitations, he may deduct 48.33% of his mixed expenses for the year (\$21,700.17).

Nigel's land has been used predominantly for a place configured as a residence and that place is Nigel's main home. Therefore, Nigel's ability to claim a deduction for his interest costs is not subject to the interest limitation rules.

For 2023 income year, Nigel calculates his taxable income as:

Salary	\$62,400
Rental income	\$22,880
less deductible expenses	<u>(\$21,700.17)</u>
	\$63,579.83

If Nigel had incurred a loss from the rental activity, the deductions over and above the amount of income would not be subject to the residential ring-fencing rules. This is

because more than 50% of the land was used for most of the income year by Nigel as his main home.

The home has not been unoccupied during the income year, so the mixed-use asset rules have no application.

### Example | Taura 2 – Calculating a deduction for depreciation of chattels

This example uses the same facts as in Example | Taura 1 except Nigel decides on 1 April 2022 to buy the following new items for his home and wishes to claim a depreciation loss:

- washing machine \$1,800
- dryer \$1,600
- air fryer \$300
- shelving unit \$2,000

The shelving unit is to be in Nigel’s toy collection space and will not be accessible to his flatmates. Nigel cannot claim a depreciation loss for the shelving unit due to its exclusive private use.

Nigel can claim a depreciation loss on the other items to the extent the loss is incurred by Nigel in deriving assessable income. The washing machine, dryer and air fryer are all available for common use. Therefore, Nigel can deduct 50% of his depreciation losses in respect of the washing machine and dryer as follows:

- Washing machine (30% DV) \$540 depreciation loss subject to 50% apportionment = \$270 deduction.
- Dryer (30% DV) \$480 depreciation loss subject to 50% apportionment = \$240 deduction.

A summary of Nigel’s fixed asset register shows:

Asset	Cost	Annual Depreciation Charge	Adjusted Tax Value	Deductible Depreciation Loss
Washing machine	\$1,800	\$540	\$1,260	\$270

Dryer	\$1,600	\$480	\$1,120	\$240
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As the cost of the air fryer is less than the \$1,000 low value asset threshold, Nigel can claim a deduction for \$150 (50% of \$300) in relation to the air fryer.

Later, Nigel decides to replace the old curtains with a more energy efficient option in each bedroom. On 1 April 2023, Nigel purchases new curtains at a cost of \$1,000 per bedroom. Nigel cannot claim a depreciation loss for the cost to replace the curtains in his bedroom. However, Nigel can deduct the full depreciation loss he calculates for the curtains in the flatmates' bedrooms as these rooms are exclusively used by his flatmates.

Curtains (25% DV) \$500 depreciation deduction for 2024 tax year.

## References | Tohutoro

### Legislative references | Tohutoro whakatureture

Income Tax Act 2007 – ss CC 1, DA 1, DA 2, DA DG 3, DH 4, YA 1, subpart DG, subpart DH, subpart EL (“main home”), Schedule 15

### Other references | Tohutoro anō

Depreciation rate finder and calculator (webpage, Inland Revenue, no date).

[www.ird.govt.nz/income-tax/income-tax-for-businesses-and-organisations/types-of-business-expenses/depreciation/claiming-depreciation/work-out-your-assets-rate-and-depreciation-value](http://www.ird.govt.nz/income-tax/income-tax-for-businesses-and-organisations/types-of-business-expenses/depreciation/claiming-depreciation/work-out-your-assets-rate-and-depreciation-value)

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*Interpretation statement IS 17/02: Deductibility of farmhouse expenses* (Wellington, Inland Revenue, March 2017). [www.taxtechnical.ird.govt.nz/en/interpretation-statements/is-1702-income-tax-deductibility-of-farmhouse-expenses](http://www.taxtechnical.ird.govt.nz/en/interpretation-statements/is-1702-income-tax-deductibility-of-farmhouse-expenses)

*QB 19/05: What are my income tax obligations if I rent out my home or a separate dwelling on my property as short-stay accommodation* (Question We've Been Asked, Wellington, Inland Revenue, May 2019). [www.taxtechnical.ird.govt.nz/en/questions-we-ve-been-asked/2019/download-qb19-05](http://www.taxtechnical.ird.govt.nz/en/questions-we-ve-been-asked/2019/download-qb19-05)

*Special report on interest limitation and additional bright-line rules* (Wellington, Inland Revenue, March 2022). <https://taxpolicy.ird.govt.nz/publications/2022/2022-sr-interest-limitation-bright-line-changes>

## About this document | Mō tēnei tuhinga

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