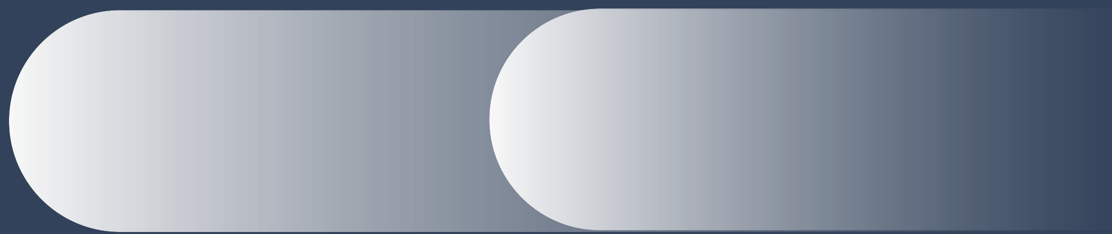
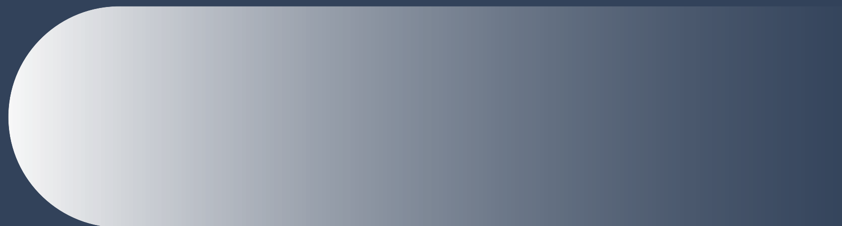
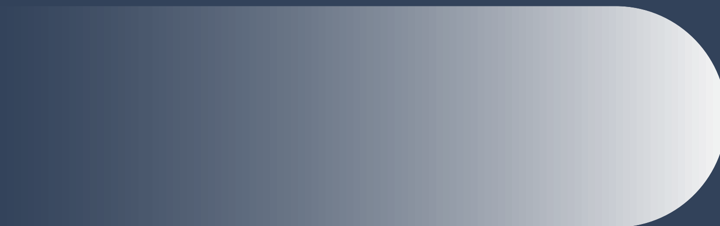
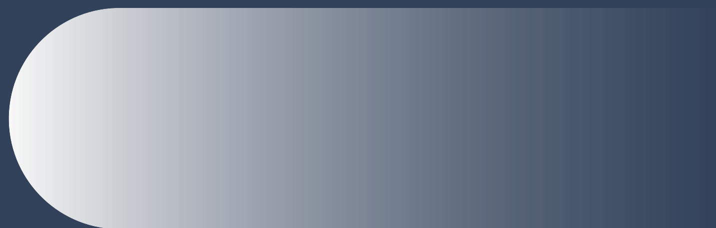
Quarantined
The New Negative Gearing Rules Explained



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Introduction

“Negative gearing” occurs where an entity’s deductions relating to an income-producing investment, such as residential housing, exceed the assessable income the entity derives from that investment in an income year. In broad terms, the resulting net loss may reduce the entity’s other taxable income, including income from salary and wages, business activities or other investments.

The new rules change that treatment for certain residential dwellings from the 2027–28 income year. Rather than allowing excess deductions to reduce unrelated income, the rules quarantine the excess and restrict how it can be used.

The starting point for understanding the new negative gearing rules is section 26-155(1) of the *Income Tax Assessment Act 1997* (Cth) (**the Act**). That provision contains the general loss-quarantining rule for residential dwellings used or held as residential accommodation.

The General Rule

1. Section 26-155(1) of the Act provides that:

   “If the amounts relating to the using or holding of residential dwellings as residential accommodation that you could otherwise deduct for an income year exceed your assessable income from using or holding residential dwellings as residential accommodation for the income year, this Act applies to the amount of the excess as follows:

   (a) it is not deductible for that income year;

   *(b) it is an amount (**a quarantined amount**) that could be applied in accordance with the method statement in section 102 5 (about working out your net capital gain) for that income year;*

   (c) to the extent any part of it remains after applying that method statement—it is treated as an amount relating to using or holding residential dwellings as residential accommodation for the next income year.”

2. The difficulty with section 26-155(1) is that the operative test is deceptively compact. Before asking whether deductions exceed assessable income, it is necessary to unpack several threshold concepts:

   (a) what is a “residential dwelling”;

   (b) when is it used or held “as residential accommodation”; and

   (c) what does it mean for an amount to “relate to” that use or holding.

   These concepts determine the boundaries of the rule.

3. Before turning to those concepts, it is useful to identify when the new regime does not apply. Section 26-155 contains two important limits on the general rule:

   (a) first, subsection 26-155(4) excludes certain entities altogether;

   (b) secondly, subsection 26-155(2) requires certain income and deduction amounts relating to particular residential dwellings to be disregarded.

   Those exclusions should be considered before working through the operative concepts in subsection 26-155(1).

Excluded Entities: When section 26-155(1) Does Not Apply

4. Subsection 26-155(4) of the Act provides that subsection 26-155(1) does not apply to:

   (a) a widely held unit trust;

   (b) a complying superannuation entity; or

   (c) an entity in a class of entities determined by the Minister by legislative instrument.

   Note: A widely held unit trust is, broadly, a fixed trust that is a unit trust and is not closely held. A trust may be closely held where one individual, or up to 20 individuals between them, have fixed entitlements to 75% or more of the income or capital of the trust.

   Note: Complying superannuation entities includes self-managed superannuation funds.

5. The Explanatory Memorandum does not provide any detailed rationale for why widely held unit trusts and complying superannuation entities are excluded, or why companies and closely held trusts are not. However, the structure of subsection 26-155(4) suggests a deliberate distinction between institutional or regulated investment vehicles on the one hand, and ordinary private investment structures on the other.

6. The fact that paragraph 26-155(4)(c) allows the Minister to determine further excluded entity classes also suggests that the entity exclusion is intended to be capable of adjustment over time. If a particular class of entity is later considered appropriate for exclusion, that can be addressed by legislative instrument. Until that occurs, companies, discretionary trusts, fixed trusts and unit trusts remain within the potential scope of section 26-155(1).

Property-Based Carve-Outs: Overview

7. Section 26-155(1) does not apply to every residential dwelling used or held as residential accommodation. Subsection 26-155(2) requires certain amounts to be disregarded for the purposes of the general rule. Broadly, those disregarded amounts include amounts relating to pre-Budget ownership interests, new residential dwellings and residential dwellings used or held for certain Minister-determined activities, purposes, businesses or enterprises.

8. These are property-based carve-outs. They do not exclude the taxpayer from the regime altogether. Instead, they remove particular income and deduction amounts from the section 26-155(1) calculation. Each of these carve-outs is considered in detail below.

Key Concepts of the General Rule

9. Having dealt with the above exclusions, the analysis returns to the general rule in section 26-155(1). For a taxpayer that is not an excluded entity, and for amounts that are not disregarded under subsection 26-155(2), the next task is to identify whether the remaining income and deductions fall within subsection 26-155(1).

10. That requires working through the key concepts used in the general rule, namely:

    (a) whether the relevant property is a "residential dwelling";

    (b) whether that residential dwelling is being used or held "as residential accommodation"; and

    (c) whether the relevant deductions and assessable income have the required connection with that use or holding.

11. These concepts matter because section 26-155(1) does not apply merely because a taxpayer owns property, or even because the property has a residential character. The provision is concerned with amounts relating to the use or holding of residential dwellings as residential accommodation.

What is a residential dwelling?

12. Section 26-160(1) of the Act defines a "**residential dwelling**" to mean a dwelling other than any of the following:

    (a) a caravan, mobile tiny home, or other mobile home;

    (b) a hotel, motel, inn, hostel or boarding house;

    (c) a dwelling providing accommodation to students in connection with a school or an education institution that is not a school;

    (d) a boat or other marine vessel;

    (e) a dwelling in a class of dwellings determined by the Minister by legislative instrument.

13. The Act does not define any of the dwellings described in 26-160(1).

14. Section 118-115(1) of the Act defines a dwelling to include:

    (a) a unit of accommodation that:

        (i) is a building or is contained in a building; and

        (ii) consists wholly or mainly of residential accommodation; and

        (iii) a unit of accommodation that is a caravan, houseboat or other mobile home; and

    (b) any land immediately under the unit of accommodation.

15. Section 26-160(2) provides that for the purpose of section 26-160(1) a residential dwelling is taken to include any of the following things to the extent that the thing is available for use by an occupant of the dwelling:

    (a) land adjacent to the dwelling;

    (b) a garage, storeroom or other structure associated with the dwelling.

16. This extension of the meaning of residential dwelling is intended to ensure that all of the land and structures that are on an entity's property are included by the term residential dwelling.

17. However, the extension in section 26-160(2) is not unlimited. The words "to the extent that the thing is available for use by an occupant of the dwelling" are important. They indicate that adjacent land, a garage, storeroom or other associated structure is only treated as part of the residential dwelling where it is connected with the residential occupation of the dwelling.

18. Accordingly, land or structures on the same title as the dwelling will not necessarily be included in the residential dwelling merely because they are physically located on the same property. If part of the land or an associated structure is not available for use by the occupant of the dwelling, and is instead used or leased for a separate non-residential purpose, that part should not be treated as part of the residential dwelling for the purposes of section 26-160(2).

Example

A taxpayer owns a 2,000 sqm lot containing a house. The taxpayer leases the house to an individual as residential accommodation. The lease gives the tenant use of the house and a small surrounding yard but excludes 1,500 sqm of adjacent land. The taxpayer separately leases that 1,500 sqm area to a company for storage purposes.

In this case, the house, and any surrounding land available for use by the residential tenant, would form part of the residential dwelling. However, the 1,500 sqm storage area would not be included as part of the residential dwelling under section 26-160(2), because it is not available for use by the occupant of the dwelling. Income and deductions attributable to the storage lease should therefore be treated separately from the income and deductions relating to the use or holding of the residential dwelling as residential accommodation.

Where expenses relate to the whole property, such as interest on a mortgage secured over the entire 2,000 sqm lot, those expenses would need to be apportioned between the residential accommodation component and the separate storage lease component.

When is a residential dwelling being used or held as residential accommodation?

19. Once the relevant thing has been identified as a “residential dwelling”, the next question is whether that residential dwelling is being “used or held as residential accommodation”.

20. This is a separate enquiry from whether the asset is a residential dwelling. A property may be a residential dwelling in character, but the section is only concerned with amounts that relate to the use or holding of that residential dwelling as residential accommodation.

21. The words “used or held” should be considered separately:

    (a) “Used” directs attention to the actual use of the residential dwelling during the income year;

    (b) “Held” is broader and may capture circumstances where the taxpayer holds the residential dwelling for the relevant residential accommodation purpose, even if it is not actually occupied at every point in the income year.

22. The phrase “as residential accommodation” then limits the relevant use or holding. The use or holding must be residential in nature. Where a residential dwelling, or part of the property associated with it, is used or held for a separate non-residential purpose, the income and deductions attributable to that separate use should not be included in the section 26-155 comparison.

23. The Bill does not separately define the expression “residential accommodation”. Accordingly, the expression should be given its ordinary meaning, having regard to the statutory context in which it appears.

Property-Based Carve-Outs: In Detail

24. Subsection 26-155(2) of the Act provides:

"For the purposes of subsection (1), disregard amounts you could otherwise deduct, and amounts of assessable income, to the extent those amounts relate to the using or holding of the following:

*(a) an *ownership interest in a *residential dwelling you last *acquired before 7:30 pm, by legal time in the Australian Capital Territory, on 12 May 2026;*

*(b) a residential dwelling that is a *new residential dwelling in relation to you;*

(c) a residential dwelling for an activity or purpose determined by the Minister by legislative instrument for the purposes of this paragraph;

(d) a residential dwelling for a business or enterprise of a kind determined by the Minister by legislative instrument for the purposes of this paragraph."

25. The practical effect is that the taxpayer does not simply identify all income and deductions connected with residential dwellings used or held as residential accommodation. The taxpayer must then remove the amounts covered by subsection 26-155(2).

26. This is an important sequencing point. A taxpayer may have a residential dwelling, use or hold it as residential accommodation, and incur otherwise deductible expenses that exceed the income from that dwelling. However, if the relevant amounts relate to a dwelling or interest covered by subsection 26-155(2), those amounts are disregarded.

First Carve-Out: Ownership interests acquired before 7:30 pm ACT time on 12 May 2026

27. The first carve-out is for amounts that relate to the using or holding of an ownership interest in a residential dwelling that the taxpayer last acquired before 7:30 pm on 12 May 2026.

28. This carve-out is directed to pre-Budget acquisitions. Its function is to preserve the ordinary negative gearing treatment for ownership interests that were acquired before the announced commencement time. Where the carve-out applies, the income and deductions relating to that ownership interest are disregarded for the purposes of section 26-155(1).

29. There are three concepts to unpack in paragraph 26-155(2)(a):

(a) "ownership interest";

(b) "residential dwelling"; and

(c) "last acquired".

30. The expression "ownership interest" is not defined in section 26-155 itself. It takes its meaning from section 118-130 of the Act. Broadly, a taxpayer has an ownership interest in land if the taxpayer has a legal or equitable interest in the land, or a right to occupy it.

31. For a dwelling that is not a flat or home unit, the taxpayer has an ownership interest if the taxpayer has a legal or equitable interest in the land on which the dwelling is erected, or a licence or right to occupy it.

32. For a flat or home unit, the concept extends to a legal or equitable interest in a stratum unit, a licence or right to occupy it, or a share in a company that owns the relevant land and gives the taxpayer a right to occupy the flat or home unit.

33. The reference to a “residential dwelling” then picks up the definition in section 26-160.

34. The phrase “last acquired” is also important. The provision asks when the taxpayer last acquired the relevant ownership interest. If the taxpayer last acquired the ownership interest before 7:30 pm ACT time on 12 May 2026, the amounts relating to the using or holding of that ownership interest are disregarded for the purposes of section 26-155(1).

35. Subsection 26-155(3) contains a specific rule for residential dwellings acquired under a contract. It provides that, despite subsection 118-130(2), for the purposes of paragraph 26-155(2)(a), a taxpayer who acquires a residential dwelling under a contract has an ownership interest in the residential dwelling from the time the taxpayer enters into the contract.

36. The practical effect is that a taxpayer who entered into a contract to acquire a residential dwelling before 7:30 pm on 12 May 2026 may fall within the paragraph 26-155(2)(a) carve-out, even if settlement occurred after that time.

> For example, assume a taxpayer entered into a contract to purchase an established residential dwelling at 4.00 pm on 12 May 2026, but settlement occurred on 30 June 2026. For the purposes of paragraph 26-155(2)(a), subsection 26-155(3) treats the taxpayer as having an ownership interest in the residential dwelling from 4.00 pm on 12 May 2026. The amounts relating to the later use or holding of that ownership interest as residential accommodation would therefore be disregarded for the purposes of section 26-155(1).

37. The Explanatory Memorandum also makes it clear that where the nature of the joint tenancy arrangement changes on or after 7:30pm on 12 May 2026 so that, for example, where one of the two joint tenants owners of a property held as a joint tenancy interest ceases to have an interest in the property, the remaining owner is treated as having acquired a new ownership interest from the departing joint tenant in a residential dwelling. This new interest (but not the original interest) is subject to the requirement to quarantine losses.

38. The Explanatory Memorandum also confirms that the following scenarios are not captured by 26-155(1):

(a) real property interest in vacant residential land on which a residential dwelling is built on the land after 7:30pm on 12 May 2026; or

(b) real property interest in land where a residential dwelling is being built or is contracted to be built and the completion of construction occurs after 7:30pm on 12 May 2026.

Second Carve-Out: New residential dwellings

39. The second carve-out is for amounts that relate to the using or holding of a residential dwelling that is a “new residential dwelling” in relation to the taxpayer. This carve-out reflects an important policy distinction in the new rules: losses from established residential dwellings may be quarantined, but amounts relating to new residential dwellings are removed from the section 26-155(1) calculation. The practical question is therefore whether the dwelling is a new residential dwelling in relation to the particular taxpayer.

40. Subsection 26-160(3) of the Act provides that a residential dwelling is a new residential dwelling in relation to a taxpayer if the requirements determined under subsection (4) are met in relation to the taxpayer and the residential dwelling.

41. Subsection 26-160(4) of the Act provides that the Minister must, by legislative instrument, determine requirements for the purposes of subsection (3). Without limiting this subsection, the requirements may include requirements relating to one or more of the following:

(a) the kind of residential dwelling;

(b) the kind of interest you hold in the residential dwelling and the circumstances in which you acquired your interest (such as whether you were the builder or a subsequent purchaser of the residential dwelling);

(c) circumstances relating to the creation of the residential dwelling (such as whether the residential dwelling was built on vacant land, was created through substantial renovations of an existing building, or was built to replace a demolished residential dwelling);

(d) whether the residential dwelling has a separate title, equitable title or similar legal interest that can be acquired by an entity;

(e) whether the residential dwelling genuinely adds to the supply of residential dwellings in Australia.

42. The important point is that the Act does not itself set out an exhaustive definition of “new residential dwelling”. Instead, a residential dwelling will only be a new residential dwelling in relation to a taxpayer if the requirements determined by the Minister are satisfied.

43. The words “in relation to you” are also significant. The question is not simply whether the dwelling is “new” in a general or colloquial sense. The question is whether the dwelling is a new residential dwelling in relation to the particular taxpayer. That may require attention to the kind of interest the taxpayer holds, the circumstances in which the taxpayer acquired that interest, and whether the taxpayer was the builder, developer or a subsequent purchaser.

> The Explanatory Memorandum gives examples of the kinds of requirements that may be included in the Ministerial determination. Those examples include a residential dwelling that has been constructed and not previously sold, including dwellings constructed as part of greenfield developments.
>
> Another example is where the residential dwelling genuinely adds to housing supply in Australia. The Explanatory Memorandum gives the example of a single residential dwelling being demolished and replaced with two separately titled duplexes. In that case, both duplexes may be treated as new residential dwellings. By contrast, where an existing dwelling is demolished and replaced with a single dwelling, that would not satisfy the requirement of adding to housing.
>
> The Explanatory Memorandum also gives the example of a unit in a newly constructed apartment block. If the developer leases the unit and then sells it within 12 months of completion of construction, the unit may still be treated as “new”.

44. The practical consequence of paragraph 26-155(2)(b) is that, if a residential dwelling is a new residential dwelling in relation to the taxpayer, the income and deduction amounts relating to the use or holding of that dwelling are disregarded for the purposes of section 26-155(1). Those amounts are therefore not brought into the loss-quarantining calculation. This means that these deductions can be applied against other types of assessable income an entity has derived.

Third & Fourth Carve-Outs: Minister-determined activities, purposes, businesses and enterprises

45. The third and fourth carve-outs are for residential dwellings used or held for Minister-determined activities, purposes, businesses or enterprises:

(a) Paragraph 26-155(2)(c) applies where the residential dwelling is used or held for an activity or purpose determined by the Minister by legislative instrument; and

(b) Paragraph 26-155(2)(d) applies where the residential dwelling is used or held for a business or enterprise of a kind determined by the Minister by legislative instrument.

46. These carve-outs are not self-executing in the same way as the pre-Budget acquisition carve-out. They depend on the making of a legislative instrument. Until such an instrument is made, it is not possible to identify with certainty which activities, purposes, businesses or enterprises will be excluded from the section 26-155(1) calculation.

47. The practical effect is that paragraphs 26-155(2)(c) and (d) operate as regulation-making powers that allow further categories of residential dwelling activity to be removed from the loss-quarantining rule. If a relevant legislative instrument applies, the taxpayer must disregard the otherwise deductible amounts and assessable income to the extent they relate to the use or holding of the residential dwelling for that determined activity, purpose, business or enterprise.

48. At this stage, because the relevant legislative instruments have not been made, these carve-outs should be treated as placeholders.

Which amounts are brought into section 26-155(1) calculation?

49. Once the relevant residential dwelling and residential accommodation use have been identified, the next step is to identify the amounts that are brought into the section 26-155(1) calculation. The provision requires a comparison between two categories of amounts:

(a) first, the amounts relating to the using or holding of residential dwellings as residential accommodation that the taxpayer could otherwise deduct; and

(b) secondly, the taxpayer's assessable income from using or holding residential dwellings as residential accommodation.

50. The words "relating to" are important on the deduction side of the comparison. Section 26-155(1) does not merely refer to deductions "for" a residential dwelling. It refers to amounts "relating to" the using or holding of residential dwellings as residential accommodation. The Explanatory Memorandum explains that this requires some connection or association between the amount sought to be deducted and the residential dwelling used or held as residential accommodation.

51. That connection or association may be direct or indirect, or substantial or real, but it must be relevant. A remote or tenuous connection will not be sufficient. The practical question is therefore whether the expense has a relevant connection with the taxpayer's use or holding of the residential dwelling as residential accommodation.

52. Expenses such as interest on borrowings used to acquire the residential dwelling, insurance, strata levies, council rates, repairs and property management fees may be examples of amounts that have the required connection, depending on the facts. However, the connection must be tested by reference to the relevant use or holding. An expense connected with a different activity or different use of the property should not be included merely because it has some physical or factual association with the same land.

53. Where an expense relates partly to the use or holding of a residential dwelling as residential accommodation and partly to another use, the expense should be apportioned. Only the part that has the relevant connection with the residential accommodation use should be brought into the section 26-155(1) calculation.

54. The practical effect is that section 26-155(1) creates a separate residential accommodation "bucket". The taxpayer must identify the assessable income and otherwise deductible amounts that belong in that bucket. Only after that exercise is complete can the taxpayer determine whether the deduction-side amounts exceed the income-side amounts for the income year.

55. In undertaking that exercise, it is also necessary to recognise that not every amount connected with a residential dwelling will necessarily be brought into the final calculation. The Act requires certain amounts to be disregarded for the purposes of section 26-155(1), including amounts relating to particular non-quarantined residential dwellings.

56. If the otherwise deductible amounts in the residential accommodation bucket do not exceed the assessable income in that bucket, there is no excess and section 26-155(1) does not quarantine any amount. If the otherwise deductible amounts do exceed the assessable income, only the excess is subject to the consequences in paragraphs 26-155(1)(a), (b) and (c).

Trust Beneficiaries: Character flow-through for residential accommodation income

57. A further modification applies where the taxpayer is a beneficiary of a trust estate. Subsection 26-155(7) is designed to ensure that, where an amount included in a beneficiary's assessable income under Division 6 of Part III of the Income Tax Assessment Act 1936 is referable to using or holding residential dwellings as residential accommodation, that amount is treated as assessable income of the beneficiary from using or holding residential dwellings as residential accommodation.

58. The effect of subsection 26-155(7) is to preserve the residential accommodation character of trust income in the hands of the beneficiary. This matters because section 26-155(1) compares the taxpayer's otherwise deductible amounts with the taxpayer's assessable income from using or holding residential dwellings as residential accommodation. Without subsection 26-155(7), there may be uncertainty about whether trust-derived income retained that character for the beneficiary's own section 26-155 calculation.

Example: Discretionary Trust	Example: Unit Trust
Assume a discretionary trust owns an established residential dwelling and rents it out as residential accommodation. In the income year, the trust has net income from that rental activity and a beneficiary is assessed on an amount under Division 6 of Part III of the Income Tax Assessment Act 1936. To the extent the amount included in the beneficiary's assessable income is referable to the trust's use or holding of the residential dwelling as residential accommodation, subsection 26-155(7) treats that amount as assessable income of the beneficiary from using or holding residential dwellings as residential accommodation. This may be relevant if the beneficiary also has their own loss-making residential dwelling that is subject to the section 26-155 quarantining rules. The trust-derived residential accommodation income can form part of the beneficiary's residential accommodation income bucket, reducing the extent to which the beneficiary's own residential accommodation deductions exceed their residential accommodation income.	Assume a closely held unit trust owns an established residential dwelling and rents it out as residential accommodation. An individual unitholder owns all of the units in the trust. The unit trust derives net rental income from the dwelling, and an amount is included in the unitholder's assessable income under Division 6 in relation to the net income of the trust estate. To the extent that amount is referable to the unit trust's use or holding of the residential dwelling as residential accommodation, subsection 26-155(7) treats the amount as assessable income of the unitholder from using or holding residential dwellings as residential accommodation. This may also be relevant where the unitholder borrowed money to acquire the units in the unit trust. If the interest expense on that borrowing has the required connection with the residential dwelling held by the unit trust, the interest expense may need to be considered in the unitholder's section 26-155 calculation. In that case, subsection 26-155(7) ensures that the residential accommodation income distributed from the trust is also recognised on the income side of that calculation.

59. The result is that subsection 26-155(7) operates as a character-preservation rule. It does not treat the beneficiary as owning the trust's residential dwelling. Rather, it treats the relevant trust-derived assessable income as income from using or holding residential dwellings as residential accommodation for the beneficiary's own section 26-155 calculation.

Modification of the excess: Net income from non-quarantined dwellings and revenue gains

60. After the taxpayer has identified an initial excess under subsection 26-155(1), but before applying the consequences in paragraphs 26-155(1)(a), (b) and (c), subsection 26-155(6) may reduce that excess. This is an important sequencing rule. The amount that is denied and quarantined is not necessarily the initial excess calculated under subsection 26-155(1). It is the excess remaining after any reduction required by subsection 26-155(6).

61. Subsection 26-155(6) reduces the initial excess by two categories of amounts:

    (a) The first is any amount by which the taxpayer's assessable income covered by subsection 26-155(2) exceeds the taxpayer's deductions covered by that subsection for the income year. In broad terms, this is net positive income from non-quarantined residential dwellings, such as pre-Budget dwellings, new residential dwellings, or Minister-determined carve-out categories.

    (b) The second is any gain realised for income tax purposes for the income year from a realisation event occurring in relation to a residential dwelling that is a revenue asset. This ensures that relevant revenue gains from residential dwellings are also taken into account before any excess is denied and quarantined.

62. Subsection 26-155(6) does not expressly apply a quarantined loss against the income of a non-quarantined residential dwelling. The statutory mechanism is different. It reduces the amount of the initial excess before the denial and quarantining rules apply. However, the practical effect is that only the reduced excess is denied under paragraph 26-155(1)(a) and becomes a quarantined amount under paragraph 26-155(1)(b).

Example

Assume a taxpayer has a post-Budget established residential dwelling that produces $50,000 of assessable income and $80,000 of otherwise deductible expenses. The initial excess is $30,000. The taxpayer also has a pre-Budget residential dwelling covered by subsection 26-155(2)(a), which produces $40,000 of assessable income and $25,000 of deductions. The net positive amount from the pre-Budget dwelling is $15,000. Subsection 26-155(6)(a) reduces the initial $30,000 excess by $15,000. The remaining excess is $15,000. Only that $15,000 is denied and quarantined under paragraphs 26-155(1)(a) and (b).

63. This rule is significant because a taxpayer with net positive income from non-quarantined residential dwellings may reduce the amount that would otherwise be quarantined from loss-making in-scope residential dwellings. It does not permit the excess to be offset directly against salary, wages or unrelated business income. However, it does mean the quarantining rule operates by reference to a modified residential dwelling position, rather than by isolating each in-scope dwelling entirely from all other residential dwelling income.

Bringing the Calculation Together

64. At this point, the taxpayer has not yet applied the loss-quarantining consequences in paragraphs 26-155(1)(a), (b) and (c). The taxpayer has only identified the relevant residential accommodation “bucket”. That bucket consists of assessable income from using or holding residential dwellings as residential accommodation, and amounts relating to that same use or holding that the taxpayer could otherwise deduct.

65. In practical terms, section 26-155(1) becomes relevant where the following matters are satisfied:

    (a) the taxpayer uses or holds a residential dwelling;

    (b) the residential dwelling is used or held as residential accommodation;

    (c) the taxpayer has amounts that relate to that use or holding;

    (d) those amounts are amounts that the taxpayer could otherwise deduct for the income year; and

    (e) those otherwise deductible amounts exceed the taxpayer’s assessable income from using or holding residential dwellings as residential accommodation for that income year.

66. Where those matters are satisfied, the amount to which section 26-155(1) applies is not the whole amount of the taxpayer’s deductions. It is only the excess. That is, the rule applies only to the amount by which the otherwise deductible residential accommodation expenses exceed the assessable income from the relevant residential accommodation activity.

67. The next question is what the Act does with that excess. Section 26-155(1) answers that question in three stages: first, the excess is not deductible for that income year; secondly, it becomes a quarantined amount that may be applied under the section 102-5 method statement for that income year; and thirdly, any remaining amount is carried forward and treated as an amount relating to using or holding residential dwellings as residential accommodation for the next income year.

Example

Henrietta acquires an established residential dwelling in July 2028. For the 2028 29 income year Henrietta has assessable income of $50,000 from renting out the residential dwelling as residential accommodation. For that year, Henrietta has (but for this subsection) $65,000 in deductions for the residential dwelling, including interest, insurance and strata costs. She can only deduct $50,000 and the remaining $15,000 is carried forward to the next income year.

For the 2029 30 income year, Henrietta has (but for this subsection) $70,000 in deductions and $52,000 of assessable income from renting out the residential dwelling as residential accommodation. She can deduct $52,000 and $33,000 is carried forward to the next income year (comprising the $15,000 carried forward from the 2028 29 income year and $18,000 from the 2029 30 income year).

For the 2030 31 income year, Henrietta has $20,000 in deductions and $72,000 of assessable income from renting out the residential dwelling as residential accommodation, having reduced her mortgage following an inheritance. She has net rental income from the residential dwelling of $52,000 for this income year and can fully offset the amount of $33,000 that has been carried forward from the previous income year.

5 Step Process (From Explanatory Memorandum)

Step 1 – Determine whether the quarantining provisions apply – entities

You are not required to complete any of the following steps if you are an excluded entity. These are a widely held trust, complying superannuation entity or an entity determined by the Minister.

Step 2 – Determine any net income amount, disregarding exceptions

Consider amounts that you can deduct (including quarantined amounts from the previous income year) and amounts of assessable income that relate to the using or holding of residential dwellings as residential accommodation. This includes amounts you receive as a beneficiary of a trust estate.

You should then disregard any amounts that you can deduct and any amounts of assessable income that are covered by the exceptions. This includes amounts in relation to the using or holding of the following:

(a) an ownership interest in a residential dwelling you last acquired before 7:30 pm (AEST) on 12 May 2026;

(b) a residential dwelling that is a new residential dwelling in relation to you; and

(c) a residential dwelling used or held for an activity, purpose, business or enterprise of a kind determined by the Minister by legislative instrument.

If, after excluding amounts covered by the exceptions, the amount you can deduct exceeds the amounts of assessable income, you have an excess amount that may be reduced in subsequent steps.

Step 3 – Determine whether the net income amount can be reduced

Consider amounts that you can deduct and amounts of assessable income that relate to the using or holding of residential dwellings as residential accommodation, that are covered by subsection 26-155(2) of Schedule 2.

If the amounts you can deduct exceed the amounts of assessable income, the excess amount is disregarded for the purposes of quarantining and you can deduct this excess amount against your other assessable income, consistent with current settings.

If the amounts of assessable income exceed the amounts that you can deduct, you then add this excess to any gains realised for income tax purposes for the income year from a realisation event occurring in relation to a residential dwelling that is a revenue asset.

You can then use the sum of these two amounts to reduce the excess from step 2.

If any excess from step 2 remains after applying this reduction, this remaining excess is not deductible for the income year and is considered a **quarantined amount**.

Step 4 – Apply your quarantined amount against any capital gains

You then apply any quarantined amounts you have in an income year against any capital gains relating to residential dwellings in accordance with the method statement in section 102-5 of the ITAA 1997 (about working out your net capital gain).

Step 5 – Carry forward any remaining quarantined amount to the next income year

To the extent you have any remaining quarantined loss after following the above steps, it is treated as an amount relating to using or holding residential dwellings as residential accommodation that you can deduct in the next income year. This allows you to carry forward any unused net rental losses to be used in future income years.

More Examples (From Explanatory Memorandum)

Example: Residential dwelling ceases being subject to the general rule requiring loss quarantining

Olivia acquires a large multi-bedroom house on 1 August 2027. She does not hold any other residential dwellings used or held as residential accommodation. Olivia immediately advertises the property for rent. On 1 September 2027, she enters into a 12-month lease agreement with Harriet, Tristan and Ada to rent the property. For the 2027-28 income year, the interest deductions on the mortgage, as well as other property expenses, are available only to deduct against her rental income.

In January 2028, Olivia applies for planning permission to re-zone her property so that it can be used as a boarding house. On 1 October 2028, approval for the re-zoning is granted and Olivia enters into boarding agreements with a number of boarders. This means Olivia's house was only a residential dwelling for three months of the 2028-29 income year, despite her earning income for the whole of that income year.

Olivia must now apportion her income from the property into rental income and boarding income and the related deductions into two categories. The property’s losses and outgoings during the first three months of that income year can only be deducted against Olivia’s rental income from the first three months of the year (i.e. they are quarantined). Olivia’s losses and outgoings for the rest of the income year (i.e. after the property is rezoned as a boarding house) can be deducted against all of her assessable income as loss quarantining does not apply to losses or outgoings incurred in deriving income from a boarding house.

Example: Quarantining of rental losses from a residential dwelling

Nikolai purchases a split-level house with dual street frontage on 1 August 2027 with a $700,000 mortgage. The house is his main residence. However, after he moves in, he decides to rent out the downstairs rooms and backyard, including a gardening shed, to a tenant to help cover his mortgage repayments.

Nikolai cannot claim a deduction for expenditure to the extent that it relates to that part of the house used as his main residence (i.e. the upstairs rooms and front yard) as it does not relate to gaining or producing his assessable income. Expenditures related to income earned from the part of the house

he rents out (i.e. downstairs rooms, backyard and shed) to his tenant are subject to loss quarantining, if they exceed Nikolai's income from this source. If Nikolai has a net loss from renting this portion of his house, the remaining losses can be carried forward to later income years and deducted against any assessable income from residential dwellings used or held as residential accommodation and any revenue or capital gains arising from disposals of residential dwellings.

Example: Ownership interest in vacant land pre-12 May 2026

David acquired an ownership interest in vacant land prior to 7:30pm (AEST) on 12 May 2026 and therefore it is not subject to the loss quarantining rules. He took out a loan to acquire the vacant land and is incurring interest charges. While the land is vacant, section 26-102 of the ITAA 1997 prevents David from deducting the interest charges (and any other losses or outgoings) in relation to this ownership.

In July 2027, David engages builders to commence construction of a residential dwelling on his vacant land. On 1 July 2028, construction is completed, and an occupancy certificate is issued for the residential dwelling and David enters into a lease agreement with Kathy to rent the residential dwelling.

For the 2028-29 and later income years David rents the property and his rental deductions continue to exceed his rental income. David is able to claim rental deductions, such as the interest paid on the loan for the land, as they are incurred in gaining or producing his rental income. The effect of this is that the total of David's assessable income, which includes salary and wages is reduced as his rental deductions exceed his rental income.

Example: Ownership interest in an established dwelling pre-12 May 2026

Maya acquired an ownership interest in a residential dwelling prior to 7:30pm (AEST) on 12 May 2026 (Dwelling A). This dwelling is her main residence and is subject to a home loan for which she pays interest and makes principal repayments.

On 25 August 2029, Maya moves to another city and seeks to rent the apartment. On 1 September 2029, Maya advertises Dwelling A for rent and rents Dwelling A to a tenant.

For the 2029-30 income year, Maya is able to claim deductions, such as interest paid on the loan for Dwelling A, against her assessable income, including her salary and wages, for the period 1 September 2029 to 30 June 2030.

Example: Applying the general rule and carrying forward quarantined losses

Tyson owns four residential dwellings which he rents out to derive rental income. Residential Dwellings A and B were acquired in 2025 and are not subject to the quarantining rules. Residential Dwellings C and D were acquired after 7:30 pm AEST on 12 May 2026 and are subject to the quarantining rules.

Treatment in 2027-28 income year

The net income from Tyson's residential dwellings for the 2027-28 income year are as follows:

Property	*Net rental income/loss in 2027-28 ($) after offsetting deduction*
Residential Dwelling A *(negative gearing applies)*	3,000
Residential Dwelling B *(negative gearing applies)*	2,000
Residential Dwelling C *(quarantined)*	5,000
Residential Dwelling D *(quarantined)*	-15,000

Step 1: Determine whether the quarantining provisions apply – entities

In all income years, Tyson meets Step 1 (exclusion of exempt entities), given he is not an exempt entity.

Step 2: Determine any net income amount, disregarding exceptions from the general rule

Tyson considers the amounts he can deduct, and the amounts of assessable income that relate to the using and holding of residential dwellings for residential accommodation. In doing so, he disregards these amounts from Dwellings A and B given they relate to using or holding residential dwellings covered by the relevant exceptions. This means Tyson considers Dwellings C and D, and whether there is an excess amount.

For the 2027-28 income year, there is an initial excess amount of $10,000 for Dwellings C and D.

Step 3: Determine whether the net income amount can be reduced

Next Tyson considers amounts that he can deduct and amounts of assessable income that relate to the using or holding of residential dwellings as residential accommodation, that are covered by subsection 26-155(2) of Schedule 2. In this case, this is Dwellings A and B, for which he has net income of $5,000 for the 2027-28 income year.

He then reduces the initial excess amount of $10,000 by this amount of $5,000, leaving a quarantined amount of $5,000 for the 2027-28 income year. This quarantined amount is not deductible for the 2027-28 income year.

Step 4: Apply your quarantined amount against any capital gains from residential dwellings

Tyson then considers if he has any capital gains relating to residential dwellings in the 2027-28 income year that he can apply the quarantined losses against, in accordance with the method statement in section 102-5 (about working out your net capital gain). For this income year he has none.

Step 5: Carry forward any remaining quarantined amount to the next income year

Tyson would then treat the remaining quarantined loss of $5,000 as an amount relating to using or holding residential dwellings as residential accommodation that he can deduct in the next income year (2028-29). This allows Tyson to carry forward the unused quarantined amount.

Example: Applying carried forward quarantined losses against net rental income and capital gains

Assume the same facts as Example 5. Tyson has a $5,000 carry forward loss from the 2027-28 income year, which is taken to be an amount relating to the using or holding of residential accommodation in the 2028-29 income year. Tyson disposes of Dwelling B in the year for a capital gain of $20,000.

The net income and capital gains from each residential dwelling is as follows:

Property	***Net rental income in 2028-29 ($)***	***Capital gain in 2028-29 ($)***
Residential Dwelling A *(negative gearing applies)*	5,000	
Residential Dwelling B *(negative gearing applies)*	-1,000	20,000
Residential Dwelling C *(quarantined)*	8,000	
Residential Dwelling D *(quarantined)*	-10,000	
Quarantined loss carried forward from previous income year	-5,000	

Step 2: Determine any net income amount, disregarding exceptions from the general rule

Tyson considers the amounts he can deduct, and the amounts of assessable income that relate to the using and holding of residential dwellings for residential accommodation. In doing so, he disregards these amounts from Dwellings A and B given they relate to using or holding residential dwellings covered by the relevant exceptions. This means Tyson considers Dwellings C and D as well as his carried forward loss from the 2027-28 income year, to determine if there is an excess amount.

For the 2028-29 income year, there is an initial excess amount of $7,000.

Step 3: Determine whether the net income amount can be reduced

Next Tyson considers amounts that he can deduct and amounts of assessable income that relate to the using or holding of residential dwellings as residential accommodation, that are covered by subsection 26-155(2) of Schedule 2. In this case, despite Dwelling B having a rental loss of $1,000, the total amount from Dwellings A and B, is net income of $4,000 for the 2028-29 in the income year.

He then reduces the initial excess amount of $7,000 by this amount of $4,000, leaving a quarantined amount of $3,000 for the 2028-29 income year. This quarantined amount is not deductible for the 2028-29 income year.

Step 4: Apply your quarantined amount against any capital gains from residential dwellings

Tyson then considers if he has any capital gains relating to residential dwellings in the 2028-29 income year that he can apply the quarantined losses against, in accordance with the method statement in section 102-5 (about working out your net capital gain). For the 2028-29 income year, he has $20,000 of capital gains relating to residential dwellings. Consistent with the method statement, Tyson applies the $3,000 quarantined amount against his capital gain of $20,000. This reduces the capital gain to $17,000 for the 2028-29 income year.

Step 5: Carry forward any remaining quarantined amount to the next income year

After following all the preceding steps, Tyson does not have a quarantined amount to be carried forward to the next income year.

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