

Property – Rental properties

Investments in rental properties have proven to be very attractive to New Zealand taxpayers if the surging growth in this area is anything to go by. If you are considering buying an investment rental property there are a number of issues to be aware of.

A number of people are buying investment rental properties with a view to building a portfolio of property for their retirement.

It is very important that these investments are structured correctly to make them tax effective.

In some instances, interest is not claimable against the rental income because the loan and ownership have been structured incorrectly.

In a recent case, a taxpayer purchased a second property to live in, borrowing funds to finance the purchase. The first property was rented out. The taxpayer tried to claim interest on the residential house loan against the rental income. The interest deduction was disallowed because the funds were not used for the purchase of the rental property.

This transaction could have been structured differently and the interest could then have been legitimately claimed against the rent.

Deductions

- Where you occupy a rented private dwelling-house and a portion of that house is used for business purposes (eg, musicians, doctors), a proportionate part of the rent may be claimed as a business expense.
- Where property has been purchased for the purpose of re-selling, any profit from rental income is taxable.
- Expenses such as rates, insurance, and repairs (less any casual rents) pending sale are deductible from the gross rentals.
- Expenses applicable to the property are deductible even though the property may be temporarily vacant.
- Where the property is held for realisation and the property returns casual rents, the expenses are deductible only to the extent of the casual receipts.

- Where property of an estate is held for letting at an adequate rental with a view to subsequent realisation, the expenses are allowable up to the rents received.
- Whether or not the excess expenditure is allowable depends on whether such expenditure is incurred primarily for the purpose of securing rents during the period or is incurred primarily for the improvement of the property.

Repairs and maintenance

Repairs and maintenance expenses are only claimable if the repairs were carried out while the tenant was still living in the house or the house was still available for renting.

Often overseas owners returning home realise the damage done to the property *after* the tenants have moved out – and because of the change to private use, Inland Revenue may not allow a claim for repairs of such damages. There have been instances in the past where such claims have not been allowed.

Rental expenses from ‘own-your-own’ flat or office allowable

You can claim expenses if you occupy an ‘own-your-own’ office or get income from letting an ‘own-your-own’ office or flat.

Usually, the company formed to own the building levies its shareholders for their share of the rates, insurance, maintenance, and other outgoings. Sometimes the levy includes a charge for depreciation, but when it does not, the owner-occupier still makes a claim at the appropriate rate on the share of the cost of the building.

Employers who take up shares in ‘own-your-own’ flat companies to get accommodation for employees are entitled to depreciation on that part of the cost of their shares in the flat-owning company which relates to the building, in the year first used.

When capital improvements are made later, the cost should be added to the cost of the building for calculating depreciation. The ‘cost of building’ that is calculated will then be apportioned to each owner-occupier in the proportion that their shareholding bears to the total shareholding in the company.

Property leased for inadequate rent

Where property is leased for an inadequate rent, or the lease makes no provision for payment of rent, IRD may determine what is an adequate rent for that property and the amount is deemed to be income derived by the lessor. This applies where:

- The lessee is a relative of the owner of the property, or of one of the owners (if the property is jointly owned), or a relative of any member of a partnership which owns the property;
- The property is leased to a company under the control of the lessor or any relative of the lessor, or under the control of any one lessor or a relative (where there is more than one lessor); or
- The property is leased by a company to any person.

LAQC's

Loss attributing qualifying companies (LAQC's) are becoming increasingly common these days. A LAQC is a company that is registered with Inland Revenue to obtain a special tax status allowing it to allocate the company's losses to its shareholders on the basis of their shareholding. The shareholders can then use these losses to offset against their other personal income.

Some taxpayers are so eager to reduce their tax liability that they transfer their income-earning assets, usually rental properties, to an LAQC which then obtains maximum finance for its purchase to generate a significant interest expense that is deductible for tax purposes – in other words, creating tax losses.

Although taxpayers may arrange their affairs so that they are tax-effective (so long as the tax benefits are secondary to the main objective of the exercise), Inland Revenue may not look at such arrangements kindly – in fact they may deem them tax avoidance arrangements.

Genuine non-tax reasons for a LAQC to purchase a property can provide the basis for a strong argument against Inland Revenue considering it a tax avoidance arrangement. Examples of non-tax reasons for a LAQC to purchase a property include the following:

- Keeping private assets separate from investment assets;
- Facilitating future transfer of ownership of property through the sale of shares; or
- Matrimonial reasons where the individual owning 100% of the property wants to transfer to an entity owned jointly by themselves and their partner.

See us first

Please contact us for tax implications that may arise from a purchase or transfer of investment properties.

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