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Marryatt

Chartered Accountants

Residential Rental Property Information

Introduction

Many people choose real estate as a way of saving for their old age. They often enjoy a subsidy from the Government through tax refunds resulting from losses.

The purpose of these notes is to give you as much information as possible about the tax aspects of your new investment and help you choose the right structure for your needs.

Disclaimer

Everyone's situation varies. For a start, no two incomes are likely to be the same. You may misinterpret or misunderstand something in these notes. Please, therefore, after reading them, consult us so we can check you have interpreted them correctly. We cannot accept any responsibility to anyone acting on this information without first consulting us.

The content of this publication is current at 21 August 2006 but can change both as a result of a change to the law or through a change to the way the law is interpreted.

These notes are divided into three sections.

1. A discussion of business structures so you can decide which one is best for you.
2. A list of expenses you may or may not claim.
3. Other tax issues of importance.

Part 1- Structure

Owning a rental property is like running a small business. Ownership comes in four forms:

1. **Sole trader:** the name we give to someone who runs a business by him or her self.

2. **Partnership:** this exists if two or more people own the property. Ask your solicitor if you should have a partnership deed to set out an agreement between the partners.

3. **Company:** Please refer to our notes entitled Residential Rental –Companies" for an explanation of what a company is and for more information about the benefits of using one.

4. **Trust:** Please refer to our notes "Residential Rental – Trusts" for more information about what a trust is and the benefits of using one.

If you have bought your property but your solicitor has not yet registered ownership, you still have time to change your choice of structure.

Residential Rental –
Sole Traders and Partnerships

Advantages of sole trader or partnership are:

1. Easy to understand
2. No set up costs
3. Easy compliance
4. Low cost compliance - the rental income and expenditure can be accounted for more easily than for a company.
5. Easy to get out of partnership by giving notice to the other partners you want the property sold and the partnership dissolved. They cannot refuse.
6. All profits/losses are allocated to partners every year.

Partnerships

There is no reason why either marital partner should not invest their money, separately.

However, switching horses when it suits may not be acceptable.

If a property is jointly owned, there is a presumption the profits or losses are being shared equally. However, this does not have to be the case. If H and W want to share the profits unequally, they need appropriate documentation to prove the unequal ownership existed from the time of purchase. Sometimes a high earning marital partner claims to own the rental property while it is making losses and then tries to say it is owned jointly once it is making a profit.

The property can become jointly owned only if the other partner buys a share or there is a matrimonial settlement, which will require re-registration of ownership.

Rearranging ownership can lead to tax avoidance issues. There is a brief discussion of this in part three.

Administration Costs

Accounting costs for sole traders and partnerships is lower than for trusts and companies.

Selling out

A sole trader just sells. A partner gives notice and the property has to be sold.

Residential Rental - Companies

To help you understand what a company is, here is a short history lesson.

Corporations (or companies as we usually call them) have existed since Roman times.

They were formed to provide an identity for a group of people wishing to achieve a particular commercial objective.

The idea of limiting the risk of the individuals in the group is a relatively modern concept. Anyone joining a business was responsible for all its debts. The notion a person could be legally relieved of this liability was abhorrent to most people.

The industrial revolution started about two hundred years ago and with it came a need to aggregate capital. People were reluctant to invest in corporations because of the potential risk of losing everything they owned should the business fail. The thought of spending the remainder of ones life in a debtors' prison did not have much appeal.

It was not until 1856 that the Joint Stock Companies Act was enacted. With it came limited liability for everyone except for bankers and insurance companies. By 1862 these two also became eligible for limited liability.

When we talk of a company today, we are normally referring to a limited liability company. Once you have paid in the capital you have agreed to, you will not be asked for any more money if the business fails.

A company is formed by applying to the Registrar of Companies who will require forms completed and signed, fees paid and will then hand you a Certificate of Incorporation. Accountants and lawyers commonly attend to this for their clients.

One person companies are permitted. A company is owned by shareholders, who elect a committee called "Directors", who, in turn, appoint management who hire the workers. You will be all these in your company.

Sometimes you will be making decisions as a director and at other times as a shareholder. We will guide you through.

Limiting risk is the prime reason for having a company. Disregard for the safety of money owing to creditors can expose directors to personal responsibility for the debts. Think twice before being a company director because it carries risks with it.

Car (see also Part 2 – Expenses)

If the company owns the car, Fringe Benefits Tax (FBT) applies if the car is also available for private use. All costs are tax deductible, including depreciation of the car.

FBT is based on the cost or the depreciated value of the car, so the lower the cost, the lower the tax. Sometimes a company car can work out quite well.

Transactions under your control should have normal commercial reality. We recommend you enter into an employment contract with your company, fix reasonable remuneration and include use of the car in the salary package.

A word of warning about cost! If you, or an associated person to you, like a close relative, are selling the car to the company, cost for FBT purposes is the amount originally paid for the car and not the price the company pays for it. Also, don't try selling the car to a friend and getting the company to buy from her. It doesn't work. If you have owned the car within two years of the company acquiring it, FBT is still based on the amount you paid.

Claim depreciation on the current market value of the car at the time you sell it to the company (or original cost if this was lower).

A car dealer can provide you with the current market value.

Employing a spouse

A company can pay wages and directors' fees without IRD prior approval. The remuneration must not be excessive. There is no need to deduct PAYE so long as the recipient is a shareholder. The income is just included in the personal tax return.

In a tax case a pharmacist had income from his rental company of about $15,000. He and his wife spent the year living in the UK so administration would have been limited.

They allocated the whole $15000 to themselves and IRD deemed the payments excessive and taxed both the individuals and the company on the same income. The court agreed with the IRD.

Interest

Companies can use revolving credit to save interest.

You can minimise your interest bill by having a fluctuating account, known as revolving credit. Put all money you receive into the company bank account and pay your bills on the last day they are due. You are keeping your borrowing as low as possible for as many days as possible. As interest is charged at a higher rate on a revolving credit account, have a non revolving account for part of the debt.

So long as the company owes you any money, it can keep refinancing the debt in this way and as the interest relates to refinancing it is tax deductible.

If your company is LAQC (for explanation see below), be a little careful. The debt needs to be incurred as a normal business transaction or the interest would not be tax deductible. If your company bought a diamond ring, the interest on money used to purchase it would not be tax deductible to a LAQC.

If the revolving credit used by an LAQC was incurred entirely to buy a rental property and at no time has there been money owing by the company to a shareholder, it would seem, as the law is interpreted at the moment, all the interest would be tax deductible.

LAQC – What is it?

Small businesses trading as a company are like partnerships with a major disadvantage.

Partners can claim losses but shareholders cannot. The law was changed in 1992 to allow, in some cases, shareholders to claim their company's losses in proportion to the shareholding. The companies are known as Loss Attributing Qualifying Companies or LAQC for short.

To be an LAQC there are a number of conditions. One of real significance is becoming personally responsible for company income tax in proportion to your shareholding.

Since you would have had to pay the tax as a sole trader or partnership, this should not concern you.

To become an LAQC, complete some IRD forms and lodge them with the department within the time allowed. You should get our assistance as it is easy to make a mistake.

Marital partners can get the best out of an LAQC by getting the losses taken off the income of the partner on the higher tax rate.

This person, therefore, needs to own most of the shares. Now remember this. If your company is going broke, deregister as LAQC before the company goes into liquidation or you could be caught with a nasty tax bill. The company unpaid debts are deemed forgiven when a company is liquidated. Forgiven debts are income. The company has to pay tax on its income and all those years ago you guaranteed to pay the company tax.

Deregistering an LAQC requires not only notification to IRD but also rearranging creditors as financial arrangements and notifying IRD of this as well. Talk to us if the situation should arise.

Other advantages of LAQC

Revolving credit (see "Interest", previous page) will usually work nicely. Be sure to always have the company owing you some money however small the amount. If at any time you owe the company money on balance, be sure to pay interest to your company at IRD prescribed rates or pay FBT.

By paying wages and director's fees to the lower income earner you can make a loss bigger and increase the tax refund for the person on the higher income.

Switching ownership when there are profits may not be so easy as IRD would probably interpret this as tax avoidance, with consequential exposure to interest charges and possible penalties. The usual solution is to sell the property to a family trust but this ***could*** give rise to a tax bill resulting from depreciation recovered. To avoid the depreciation recovered you could leave the property in the company and transfer the shares to the trust. Profits would then need to be transferred to the trust as dividends, which would normally have a 33 percent tax credit attached to them. These dividends would have to be passed on to beneficiaries.

No further tax would be payable by the trust. However, you would need to re-elect to maintain qualifying company status or you would lose tax credits for tax paid by the company.

As you can see, there are complications and it is best to sort them out with your accountant.

Disadvantages of forming a company include:

1. Cost of forming a company
2. Filing the annual companies return
3. There is another tax return to complete.
4. There is more tax compliance. For example: keeping an imputation credit account, which is a running record of taxes paid and amounts applied to dividends.
5. A proper set of accounts has to be prepared
6. Compliance with the Companies Act 1993, particularly when wanting to declare dividends 7. The risk of making tax mistakes is greater, particularly when transferring shares. This includes losing the imputation credits, LAQC status or right to carry forward losses. **Don't change shareholding without taking advice from us**.
7. It may be difficult to find a buyer for your shares, particularly if you are offering to sell a minority shareholding (less than 50 percent). Unlike a partnership, a minority shareholder cannot force the other shareholders to sell the property. Minority shareholders can find themselves locked in unless there is a shareholders' agreement or provision in the company constitution.

Administration costs

1. Company formation costs
2. Preparation of annual return to Registrar of Companies, annual financial statements and other accounting work such as documentation for declaring a dividend to distribute profits.

Selling out

To get out of a company, you need to find someone to buy your shares. You cannot force a sale of the property unless you have a majority of the shares or there is provision in a shareholders' agreement or the company constitution. Transferring ownership to a new shareholder, once one is found, is easy and the cost is low.

Residential Rental - Trusts

Companies were formed to protect their shareholders from losing their wealth.

Trusts go even further back in time. One of their popular uses was for dodging tax because tax was levied on land holdings and the identity of the true owner of land was concealed. However, even though trusts are still used to reduce tax, it is not the prime reason for having one. We usually call trusts “family” trusts where they relate to a family.

Here is an illustration to show you why trusts were needed.

150 years ago travel was very slow. A trip from Europe to NZ and back, allowing some time in the country, would probably have taken the best part of a year. A person taking such a trip might ask a close friend to look after his wife and family while he was away and hand him a bag of money. By doing this he would have created a trust.

The friend would be the trustee, the family would be the beneficiaries and the name given to the man going overseas would be the settlor. If he were to have written some notes to tell the trustee what he wanted, he would have created a “trust deed”.

Now you know what your solicitor is doing when she gives you a 30 page document.

She is writing out a list of instructions for the trustees: a trust deed. With the passage of time people started to ask questions such as:-

I am the settlor. Could I also be a trustee and could I be a beneficiary? The answer is, yes. Most trusts have those who created them included as trustees and beneficiaries as well. Note: You do not have a trust if you are settlor, sole beneficiary and trustee. The reason is there is no one really being entrusted.

You should consult a solicitor if you intend setting up a trust. Make sure the powers which the trust deed is conferring on the trustees are what you want.

Read and understand your trust deed before you sign it. If in doubt, give your trustees the widest possible powers.

Trusts are created to protect your assets from claims against you and from the state taking your wealth. When considering your liability to contribute to long term care, Work and Income looks at all transactions with your trust for the last five years and any money transferred to it is treated as your own. The department could go back for a longer period of time but it does not. This asset testing is to be progressively phased out from 2005 but very slowly.

The government could easily bring back estate duty.

Assets owned by your trust for two years are protected should you go bankrupt.

It is quite difficult to get rid of your assets to your trust. If you make gifts totalling more than $27,000 in any 12 month period you must pay gift duty. If

you want your trust to own your rental property you have to lend it your equity. Any capital gain, should the trust sell the property, belongs to the trust.

Here are some ways to make your trust wealthier.

1. Sell it assets which are expected to rise in value.
2. Annual gifting
3. If your business is a company, have the trust own most of the shares and pay it dividends. Warning – you will need to pay yourself a realistic income from your business. Discuss this with us.
4. Some folk provide the services of their business through a company but 80 percent or more of this services income comes from one source or related sources. In this case, all the company income is treated, for tax purposes, as though it were their personal income, anyway. By leaving a large profit in the company, these people have the opportunity to pay big dividends to the family trust, thus transferring wealth to it.
5. If you are in business, minimise your own income and live off debt repayment from your trust.
6. When you die leave all your assets to your family trust
7. If parents are leaving their estate to you, get them to leave it to your family trust.
1. It is better to pay 33 percent tax in a trust than 39 percent in your own name. Also, you may allocate as much of the trust income to beneficiaries as you wish, so long as they are over 16 years of age at the balance date of the trust. If they are on low rates of tax, the income will be taxed at 19.5 percent. Those under 16 can get up to $1000 per year and pay 19.5 percent but don't go a cent over or you will pay 33 percent on the $1000 as well. If your company is an LAQC, remember that all dividends from the company must be distributed to beneficiaries

Record keeping - trusts

Record keeping is more onerous for trusts than companies.

Trustees need to be present for decision making and their decisions need to be minuted before being acted upon. Ratifying decisions later is not acceptable. Suppose you wanted the trust to buy some shares in a company. The transaction could be either:

1. An investment of the trust
2. A repayment of part of the loan owing to you and applied to buying shares
3. A distribution from income applied to buying shares for you
4. A distribution from capital applied to buying shares for you.

If you were to ratify later there would be no evidence to show you had not changed your original decision. Regardless, it could never be a decision of trustees if one was not there at the time the decision was made.

Revolving credit suffers from the same defects as for a sole trader and partnership.

You may not mix your own money with the trust's or there is no trust.

Learn all about trusts

A number of books have been written about trusts. Don’t settle for one author only as you will find there are differing views. You can also attend seminars.

Trust losses are locked in

You can only claim rental losses in your trust against other trust income. The losses are locked in and carried forward until there are profits. Company dividends are no use as other income because the tax is already fully paid and the credits cannot be refunded to the trust. They can only be used to save tax at some future date.

Part 2 – Expenses

Residential Rental Property

Claimable Expenses

Check through this list carefully to maximise your legitimate claims. As you will see, there are many expenses to consider.

Accountancy

Deductible

- Preparation of annual accounts and tax returns
- Most company compliance costs
- Tax advice

Not-deductible

- Forming a company
- Evaluating possible property purchase options

Advertising

Deductible

- For tenants
- Other directly relating to deriving income

Not deductible

- Property for sale
- Costs not related to ongoing derivation of income such as resource consent.

Agent's fees

Deductible

- Letting fees
- Maintenance fees
- Rent collection

Not deductible

- Fee charged for buying or selling the property

Bank fees

A liberal view is taken. All costs relating to finance are tax deductible including the application fee.

Release fees charged for early loan repayment can be tricky. There has to be a business advantage for the fee to be deductible.

Release fees paid at the time of sale are not tax deductible

Car expenses

You will usually need to use a car to administer a property. Most people keep a log book and claim based on the number of kilometres they have travelled. At present, the first 3000 kilometres per year can be claimed at 62 cents per km and for the next 2000 kms the rate is 19 cents per km. Any travel over 5000 kms has to be based on actual costs. For travel over the limit, you may prefer to claim the 5000 kms maximum, which works out at $2240, rather than calculate the actual cost.

Company

- Fringe benefit tax (FBT) applies if the company owns the car
- You may prefer to claim costs on a mileage basis and not supply a car to the company.

Trust

- The trust can own a car and you can claim a share of actual running costs and depreciation. You will need a log book.
- If the vehicle is supplied to an employee of the trust, FBT will apply and you will not need a log book.
- You may prefer to claim costs on a mileage basis and not supply a car to the trust.

Cleaning

Relate this expense to its cause. If tenants left your house in a mess then cleaning is deductible.

Cleaning up after tax deductible maintenance costs would be tax deductible.

Rubbish removal after putting on a new room is part of the cost of that capital improvement.

Depreciation

If you decide not to claim depreciation, you are not permitted to change your mind later.

Depreciation is calculated on a monthly basis. If you buy on 30 January you count January as one of the months for depreciation purposes.

If you under-claim, you are deemed to have made the claim but without a tax deduction. When you sell the under-claim is added back to the book value so your loss on sale is reduced, or gain increased.

You can use current government valuation, if you do not have a valuation to apportion the selling price as this might save you money. If the house value has gone down and the land gone up, as usually happens, you may find all the house depreciation is not recovered. There maybe a benefit in paying for a proper valuation. Special rules apply if transferring between entities.

If transferring between entities, such as from you to a family trust, a special rule applies.

The new entity may not claim depreciation at a better rate or on a bigger amount than you would have been entitled to claim. The family trust may have bought from you at a much higher value than you paid for the property but the basis for claiming depreciation has to be the same as it was for you. There is a way out of this problem.

A judge said a family trust should be entitled to claim depreciation as though the property had been bought from a stranger. The case is called the Lys case.

You can apply to IRD for permission for your family trust to claim depreciation based on its purchase price. IRD is not consistent in granting of approval. Your application may be declined on the grounds it does not fit the Lys case perfectly. If this happens you may need to be prepared for us to argue your case if you wish to pursue it further.

Depreciation rates applying to assets used in residential rental properties

The first column of figures is the diminishing value rate and the second is the cost price rate. If you are unsure, ask us and we will explain in more detail.

These rates apply from 1 April 2005

	DV	CP
Residential rental property chattels (default class)	40	30
Appliances (small)	50	40
Blinds	25	17.5
Carpets	40	30
Curtains	25	17.5
Dishwashers	30	21
Drapes	25	17.5
Dryers (clothes, domestic type)	30	21
Freezers (domestic type)	25	17.5
Furniture (fitted)	13	8.5
Furniture (loose)	20	13.5
Heaters (Electric)	67	67
Heaters (gas, fitted)	25	17.5
Heaters (gas portable)	40	30
Lawn mowers	50	40
Light fittings	20	13.5
Linen	67	67
Microwave ovens (domestic type)	30	21
Ovens (domestic type)	25	17.5
Refrigerators (domestic type)	25	17.5
Stereos	40	30
Stoves (domestic type)	25	17.5
Televisions	40	30
Vacuum cleaners (domestic type)	67	67
Video recorders	40	30
Vinyl flooring	20	13.5
Washing machines (domestic type)	30	21
Water heaters	16	10.5

If the assets are new add 20 percent to the depreciation rates. For example, a domestic stove will depreciate, using diminishing value at 25 percent if not new and 30 percent if new.

Gardening

The cost must relate to deriving income. If you live in part of the property, then apportion the gardening costs on the basis of floor area let to floor area you occupy unless there is a more equitable basis. Be prepared to justify your decision.

Insurance

Deductible

- Fire and general
- Loss of rents
- Contents
- Mortgage repayment insurance

Not deductible

- Personal such as life, health etc
- Share of any insurance relating partly to your home.

Interest

- On money used to buy a rental property is tax deductible.
- On money used to buy a new home for you and retain your old home is **not** tax deductible because your borrowing is to buy something for your own use. If you want to retain your home for rental sell it to a company or trust. Here is the logic:
  The company or trust buys a house from you and raises money for this purpose. There is a direct connection between the income and the loan.
  Interest is tax deductible. You can use this money to buy your new home.
  Watch your bank and your solicitor.
  Both have been known to mess things up. If the loan is to a company or trust, having the documents drawn up with you as the borrower is not very clever. The lawyer receiving the money should put it in an account in the company's or trust's name, and then transfer it to an account in your name to pay for the house. If the money is put straight into an account in your name, it looks as though you are the borrower, which is just what you don't want.
- On money borrowed and used for two purposes is to be apportioned. If you live in part of the property, apportion all costs between business and private.
- The principal (non interest) part of a loan repayment is NOT tax deductible.

Legal Expenses

Deductible

- Arranging finance
- Relating to tenants

Not deductible

- Buying or selling the property
- Company formation

Lawyers seldom show the tax deductible part of their fee separately. Try to get yours to do this.

Power

Paying the tenants power bill, if you have to, and power bills incurred in maintaining the property are tax deductible.

Printing stationery & postage

You can claim these so long as they relate to the on-going derivation of income. The amounts are usually small.

Rates

- Look for an adjustment for rates on your lawyer's statement made at the time of purchase
- The total for the year on your rates bill is not correct as councils have a June balance date. Use your actual rates payments

Repairs and Maintenance

This can be tricky.

Major costs shortly after purchase may have to be added to the cost of the property.

Costs increasing value as opposed to restoring it, like adding to floor area, add to cost of the house.

Do repairs while you still have a tenant or between tenants if you are thinking of moving into the house.

It pays to get advice on the extent to which you can make expense claims under this heading.

Seminars

Deductible:

- Learning about tax and other law
- Learning about on-going business issues

Not deductible:

- Learning about buying or selling property

The tax deductibility rules are similar to legal costs. If the cost relates directly to deriving income it is claimable.

Telephone

- If you need a telephone so tenants can contact you and you can administer the property, claim half of the rental unless you can show more is justified.
- IRD has not provided any guidelines for cell phones.

Travelling expenses

Based on prime purpose of the trip

- Business only
- Primarily business
- Part business part holiday
- Primarily holiday

If your only reason for travel is because of the property, all costs are tax deductible so long as they are related only to the ongoing deriving of income and not to buying or selling your investment. Otherwise consider the prime purpose of the trip.

Firstly where business is the prime purpose

The airfares or other costs of getting there are fully deductible. Apportion accommodation and food on the basis of the number of days engaged in business and the number of days engaged in holiday. You could have a situation where the prime purpose is business but the holiday element is more than 50 percent. Obviously, the greater the time you spend on holiday and the less on business the more the trip takes on a prime purpose of holiday.

Secondly where the trip is partly business and partly holiday

In this case all the costs should be apportioned on a time basis. Your objective should be to show your claims are fair and reasonable.

Thirdly where the prime purpose is holiday

In this case none of the air travel is claimable. Apportion accommodation and food based on the number of days on business compared with the number of days on holiday.

Remember the general rule:

You have to be prepared to prove your case.

While you are away, keep a diary with details of what you did.

Valuations

Deductible

- To get finance
- To value chattels

Not deductible

- To check on purchase price
- For purposes of sale

The rules for tax deductibility of valuations are similar to legal expenses. A valuation to get finance is tax deductible but for deciding whether to purchase the property is not.

Use of your home

You can claim for the use of your home for running your business based on area used. If you are using the room only part of the time for administration, apportion on a time basis.

In the Castle case a solicitor used his dining room table for working one third of the time and as a dining room two thirds of the time.

He claimed a share of the area of the dining room and then took one third for a tax claim.

He won his case against the IRD.

If you have an office it will contain a desk or table, chairs, carpet, drapes etc. You can claim depreciation of them as well as on the house. However, be careful the costs of accounting don't exceed the benefit you will get. The claims are usually quite small and most people do not claim.

Wages

You may claim wages paid for administering your property, such as collecting the rent, getting new tenants arranging for repairs and maintenance etc. Be ready to justify the wages, particularly if paid to a family member.

If a sole trader pays wages to a spouse apply to IRD for written approval before payments commence. You must deduct PAYE.

Partners should enter into a three year agreement.

Companies do not have to deduct PAYE so long as the employee is a shareholder. The income must be included in the shareholder's tax return.

The more you can transfer income from a person on a higher income to one on a lower income, the more tax you can save.

Part 3 – Other tax issues of importance

Boarders and flatmates

There is a set of "Standard Costs" which set the costs you can deduct from the boarding income you receive. If by doing so you create a loss you cannot claim the loss. The current cost figures (starting from 1 April 2006) are 1 or 2 boarders $207 each per week 3rd and subsequent boarders $168 each per week.

These cost figures may be changed from time to time. Check with us for the latest from Inland Revenue.

You may keep actual expenditure figures, if you wish.

Chattels need to be valued

If you need a valuer, be sure to get the chattels in the house valued as well as the whole property. It will not cost you much more and is likely to make a big difference to your tax savings.

You can value the contents of the house yourself if you wish but do you have the expertise? It is more convincing to the IRD if someone, independent from you, has done it. Valuers are usually well worth their fee.

Houses rise in value, otherwise why would you be considering this type of investment?

When you sell you will probably have depreciation recovered on the sale of the house, and this will be taxed. Chattels, on the other hand, fall so there is unlikely to be much depreciation recovered. It follows the higher the value placed on chattels the better.

You might be wondering why you should claim depreciation on the building at all, if it is going to have to be given back later. Well, sometimes properties are sold at a loss. You are not allowed a deduction for a loss on sale of a building. So claim your depreciation or risk losing it. Trade cycles as well as local and central government policy changes can hurt the value of your investment.

Evasion is illegal, avoidance is legal BUT….

Evasion is hiding your income from IRD or knowingly making illegal claims.

Avoidance is legal but can be upset by the IRD. You need to know those arrangements most likely to be accepted and those which would not. Let's start with a marital partnership.

If H wants to buy a rental property, that's fine. If W has separate money and wishes to lend it to H and get interest, that's also fine.

If H has a high income and the rental property will be making losses, then the choice of H owning, may be better than going into partnership with W, and this

would not be tax avoidance. Similarly, if W gets a high but justifiable rate of interest this should also be acceptable.

Tax avoidance can arise from either rearranging (as opposed to arranging) your affairs to reduce tax or creating an artificial arrangement with tax as the motive. For example, buying a rental property and living in it as a tenant paying rent, where the rent is less than the outgoings. The loss is a private cost and not tax deductible.

Any device which includes the purpose of tax avoidance can be upset by the IRD.

GST

GST does not apply to an ordinary domestic rental property. There may be situations where the domestic property is used like a motel or boarding house and in those cases GST could apply. If you have any doubts you will need to seek advice.

Inherited property

Depreciation is based on the lower of cost or market value. Your cost is nil.

You could buy the property you are going to inherit, from the executor. Since you bought it, you can claim depreciation based on the cost.

If you were to sell your inherited property to a family trust or company you may be able to apply to claim depreciation based on the price the entity paid; see the Lys case above.

You could claim a deduction for interest on money borrowed to buy the property from you and use the cash to clear the mortgage on your home thus converting non tax deductible interest into tax deductible interest.

“Mates rates” - renting to a friend

Friends and relatives may not have cheap rent. Adjust your income, for tax purposes, up to normal market rents.

Negative gearing

Gearing is similar to what happens in your car. Use low gear on hills (difficult times) and high gear on the flat (easy economic times). Business gearing is the ratio of borrowed money to your own money. Use more borrowed money and less of your own in good times and vice versa in bad times.

Unfortunately bad times have a habit of arriving when you are not expecting them.

Next economic downturn some people will get burned by being too heavily committed to debt. It has happened before.

By the time you add all your costs together, including a large amount of interest, plus allowable depreciation, you will often find your tax deductible expenditure is greater than your rental income. That is to say you are deriving negative taxable income. This is known as negative gearing. The losses will generate tax refunds or reduce your tax debt:

The higher your rate of tax, the bigger the refund.

Why do this - Because you are expecting non taxable capital gains.

Overseas property

There is a little known and nasty tax awaiting you. If you borrow money overseas and the lender does not have a branch of its business in New Zealand, you must pay Non Resident Withholding Tax at 10 percent on the interest. The lenders can normally claim this back in their own country. Failure to pay this tax will attract Use of Money interest and possibly penalties. Get some advice.

Once you have registered with the Inland Revenue Department, you may apply to join an alternative scheme. Instead of Non Resident Withholding tax you can pay 2 percent Approved Issuer Levy. IRD will not allow you to back date the application. It wants its 10 percent plus penalties up to the time of registration.

If you own an overseas property, you will need to put in a tax return for both countries.

The Australian Tax Office, known as the ATO, requires chattels to be valued by a registered quantity surveyor. Do it yourself is not allowed.

The Australians have a different way of calculating depreciation from ours and the tax rates are different.

We have double tax agreements with a number of countries allowing you to claim tax paid overseas against your New Zealand tax. The claim is limited to the amount of tax you pay in NZ on that income.

Many countries, including Australia, have a capital gains tax. We don’t.

Rental from your Australian property, having a June 30 balance date is included in your New Zealand income in the following year. For example, income for the year ended 30 June 2003 belongs in the March 2004 tax year.

Alternatively you may calculate the correct rent to 31 March each year.

Owner moves into rental property

If you move into your rental property, apportion expenses on a time basis between tax deductible against tenant’s income and non tax deductible for the period you have been resident. Depreciation recovered is taken into account on the first day of the next financial year not in the year you move in. This means any depreciation recovered comes into the following tax year after you occupied the property; 1 April for most people.

Expenses incurred after the tenant leaves, such as redecorating, are personal.

Pay off your home mortgage first

If you pay off your home mortgage first you are getting rid of non tax deductible interest.

You can always borrow on the house again to buy another rental property and the interest will be fully tax deductible.

The Inland Revenue Department publication IR264 is extremely good. Be sure to get a copy and read it.

Property developers owning a rental property

We will use the term "Property Developer" loosely to include any one

- In the business of dealing in land or land/buildings
- In the business of subdividing or developing land
- In the business of erecting buildings

Note the wording "In the business of". The particular laws will not apply to a salary and wage earner or someone depending on the circumstances who is not actually in business. e.g. person has some spare land and subdivides it in a simple way and sells it. Also a real estate agent is in the business of marketing, not buying and selling land. You should be aware that "Property Developers", can be taxable on the sale of any of their Real Estate, including rental properties. We cannot give you the complicated rules here.

Associated Persons

The law may also apply to a person who is legally associated under the law to any "Property Developer". The definition of an associated person for this test is very wide and includes

- Husband and wife
- Parent and an infant child
- A trust and any person who has or can benefit under a trust
- A company and any two or more of the above that have 25 percent or more of the shares in that company
- Any partner and a partnership
- Two companies which are 50 percent or more common owned or controlled by the same persons
- A partnership and any person where that person is any of the above AND YOU CANNOT USE NOMINEES TO GET OUT OF IT

Timing

The law that could potentially tax the capital profit on the sale of an honest straight forward rental property has a timing test in it. The rules apply only if you bought or acquired the rental property "at the time" you were a "property developer". So if you become a "Property Developer" after you bought the rental the law will not apply.

Way Out

If you are caught and you have not sold then you may be able to get out of the capital gains tax if you hold the rental property for more than 10 years. This will not apply if you are a property developer and the rental was purchased as a part of your "business".

Example

You are a builder and you build a house to sell but decide to rent it out because of the market: then even waiting the 10 years will not help. However if the builder buys a rental property and does some work of more than a minor

nature on it, then providing he/she waits the 10 years after the work is complete, they will be OK.

Different Rules-Whether you are a

Dealer, Subdivider/developer or Builder

There are some variations in the rules depending on whether you are a

- Dealer,
- Subdivider/developer or
- Builder

  Example

  If you are builder and buy a rental property but you don't do anything more than minor improvements to that property then any profit wouldn't be taxed even if sold under the 10 years.

Revolving credit

Revolving credit is a great way for a company to reduce a mortgage. The following explains why revolving credit is bad news for the sole trader and partnership.

Interest is tax deductible so long as the money has been borrowed to derive income.

Suppose you borrow $100 and repay $20 then you will agree your borrowing is now $80. Interest can now only be claimed on the $80.

If you then increase your borrowing for living purposes by $10 the interest on the extra $10 is not tax deductible because the money has been borrowed for a private purpose. You owe $90 but can claim interest on only $80.

Repay another $20 and the original debt of $100 is now $60.

NOTE every time you repay you reduce the original debt regardless of how much you borrow back. You will soon find yourself having a significant debt but no ability to claim the interest on it.

Retaining your home for rental

If you move and keep your home for rental, the costs relating to that house are tax deductible in the usual way. Depreciation is calculated on what you paid for the house even if it was bought many years ago. You can get chattels valued and claim depreciation on valuation or cost which ever is the lower.

Concluding remarks

As you can see the tax issues relating to Residential Rental Property are a big subject. I have tried to provide wide coverage and sufficient detail to give you a reasonable picture. At times I have had to advise you to get extra help.

What should you do now?

1. Learn the parts which apply to you.

2. Check your situation with us and ensure your understanding is correct.

3. Do this by compiling a list of questions. Even if the answers seem obvious to you, ask the questions anyway. It is so easy to misunderstand.

Property ownership is often interesting and challenging. There is a lot more to learn other than tax. Learn the Residential Tenancies Act and read widely. Be careful and hopefully build up a nice nest egg for retirement.

Good luck.

Sharon

Sharon Marryatt