

TAX ON RENTAL PROPERTIES

INTRODUCTION

While this handout deals primarily with residential rental, the same principles apply for commercial property.

To obtain the maximum tax benefits from a residential property investment requires planning prior to the actual purchase.

Too often we have clients approaching us seeking advice after the purchase has been completed. In many cases it is too late, or more expensive to put in place tax effective structures and therefore the ability to maximize future ongoing tax benefits.

You are making a significant investment. Tax benefits can be crucial to the overall return on your investment.

ACTION: Seek professional advice prior to making your purchase. The initial cost can easily be recovered with sound planning at this stage.

OWNERSHIP STRUCTURE

With the exception of professional landlords, who derive income exclusively from residential rental, the vast majority of people have residential property as part of their overall investment portfolio. Typically you will be in some form of employment/business already generating taxable income, which is currently taxed at a rate determined by that level of income.

In New Zealand individual tax rates from 1 October 2010 are:

\$0	-	\$14,000	10.5%
\$14,000	-	\$48,000	17.5%
\$48,000	-	\$70,000	30%
\$70,000 +	-		33%

To maximize tax benefits, or put a different way minimize the incidence of tax on household income is very dependent on the structure you choose. Consideration should be given to allocating income to taxpayers who enjoy a lower tax rate such as spouses and children who may be earning little or no income.

For every \$1,000 taxable rental income a benefit of up to \$225 can be obtained if income can be allocated to the taxpayer on a lower marginal rate. Extend this over the life of your investment and savings become significant.

If your rental property is in a loss situation the reverse applies. You want to stream the loss to the taxpayer on the highest marginal tax rate.

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Whatever you do however you must keep in mind that the structure must be commercially realistic, otherwise the IRD may challenge it as tax avoidance.

Therefore the ownership structure of any property purchase is an important consideration.

The options are sole ownership, partnership, trust, limited liability company or look through company (LTC).

Each structure has benefits and costs - therefore careful consideration is required.

ACTION: Prior to purchase, ensure a tax effective ownership structure is put in place.

DEDUCTIBLE EXPENSES

Not all expenditure you incur will be deductible for tax purposes.

The following commentary will identify what expenditure is deductible and what steps you can take to maximize the amounts able to be deducted.

We prepare many rental statements for clients and by far the most significant expenses are interest on borrowings and depreciation.

INTEREST

The test for deductibility of interest is the purpose for which the funds were used. You only get a deduction for interest on funds used in your renting business.

Again planning before you purchase is essential.

In most cases there will be significant borrowings required in making your purchase. Also it is likely you will already have a mortgage over your own home. Only interest on those funds actually borrowed to complete the purchase will be deductible.

You may be borrowing 100% to complete the purchase. Likewise you may have cash that you wish to use.

What is the point in using your cash reserves in the rental property while you are paying interest on other non-deductible borrowings. Discuss the situation with your bank manager. A good solution could be to use any cash earmarked for the purchase to repay current personal borrowings, and maximize the borrowings to complete the rental property purchase.

Remember the money borrowed can be secured by other property.

Also any interest on further borrowings made subsequent to the purchase for development or improvement to the property will also be deductible.

ACTION: Work together with your accountant and bank manager to structure your borrowings in such a way as to maximize the amount of debt directly attributable to the rental property.

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DEPRECIATION

In recent years the Inland Revenue Department have made significant changes to the depreciation claims available and have further defined the classes of assets for which a deduction is available. Schedules showing the types of asset for which a higher depreciation claim may be available are included on Pages 7 and 8.

Too often we see the situation where landlords are not obtaining the full benefits available to them. As you can see from the schedules there are a large number of categories available for commercial property. For residential property the list is far more restrictive. Depreciation is based on the cost price of the asset. Land is **NOT** a depreciable asset. You need to allocate the purchase price between land and improvements and chattels if any. This can be done by reference to the latest Government valuation or a registered valuer's report.

We suggest for a small outlay you prepare, for commercial properties, an inventory of all assets associated with the property and obtain a market valuation of these.

This enables a detailed depreciation schedule to be prepared and therefore depreciation deductions to be maximized.

The default rate of depreciation for each major category is:

Buildings	Nil
Chattels	40%
Fit Out ⁽¹⁾	8%

⁽¹⁾ IRD will now only allow Fit-out to be depreciated where it is not an integral part of the buildings. See attached list.

ACTION: Complete an inventory of all assets purchased and assign appropriate values to maximize the depreciation claim.

One other point that needs to be considered in relation to depreciation is that on the ultimate sale of the property, the difference between the written down book value and sale price, or the original cost, whichever is the lesser is depreciation recovered. This becomes part of your taxable income in the year of sale. Any amount received in excess of cost price is a capital gain and is currently tax free.

On sale of commercial property you need to consider whether it is worth getting the fit out valued to minimise any depreciation recovery.

If assets (chattels and fit out but not buildings) are sold for less than book value the loss on sale is deductible in the year of sale.

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OTHER DEDUCTIONS

Accounting Fees	These are deductible, but setting up fees are not, e.g. viability fees. Fees relating to advice and assistance with financing are deductible.
Advertising	This includes all costs regarding letting the property (not selling).
Agent's Fees and Commission	<p>If you use an agent to collect the rent and/or maintain the property, you can deduct the cost of the agent's fees. Commissions paid to an agent to find tenants for the property are also deductible.</p> <p>Commission paid to real estate agents on sale are not deductible, but reduce the overall sale price and therefore will impact on depreciation recovered.</p>
Books/Periodicals	These are allowable, providing they are incidental to gaining and producing rental income.
Capital Expenditure under \$500	Many items you purchase while of a capital nature, and therefore generally not deductible, may be claimed if under \$500 i.e. table, chairs etc.
Communication	This includes fax, cell phones, couriers and delivery fees etc.
Education Expenses	Expenses incurred in attending courses, seminars, etc which are designed to update the knowledge in the rental field, are deductible.
Home Office Expenses	Your home office must be an area that you have set aside principally for business use. Inland Revenue Department says it cannot be a bedroom, nor any part of any other room of the home. It must be able to be closed off from the rest of the house. A deduction is allowed for that part of the outgoings which relate to the use of the home for the rental related activities, i.e heat, light, power, rates interest on mortgage, house and contents insurance, furniture, equipment, carpet, repairs and maintenance, as well as depreciation.
Insurance	A deduction is allowed for insurance premiums paid on policies covering losses from fire, earthquakes and other causes when the expenditure is an ordinary rental operating expense. An annual valuation fee paid to a valuer to value assets or risks for insurance purposes is also deductible.
Legal Fees	You may deduct all legal fees in arranging mortgage finance, drawing up tenancy agreement, bank administration fees for the mortgage and cost of valuation if bank requires one. Fees incurred in collecting rental arrears are also deductible. (Legal fees regarding the purchase or sale are NOT DEDUCTIBLE), unless total legal fees for the year are less than \$10,000.
Mortgage Repayment Insurance	Fully deductible, but must relate to borrowings for rental property.

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Motor Vehicle	<p>If you run a motor vehicle in the course of renting out your property, you may be able to claim the vehicle running costs. The simplest method is to use the motor vehicle reimbursing rates or Inland Revenue distance rates. These mileage rates are calculated on the average cost to run a motor vehicle.</p> <p>You must keep a log book to show dates of each trip, distance traveled and reasons for trip.</p> <p>The other option is to calculate this on the basis of actual expenses. Again a log book is required. If you choose to use this method you need to keep a log book for the test period of three months every three years.</p>
Rates	Fully deductible.
Repairs and Maintenance	<p>The cost of any repairs and maintenance that you do on the rental property is deductible. This includes gardening costs.</p> <p>N.B. 1 Repairs on earthquake strengthening may not be deductible.</p> <p>N.B. 2 If the previous owner has allowed the property to deteriorate necessitating repairs to place it in a income earning position, then these repairs would increase the value of the asset and not be allowable as an expense. Be careful doing major repairs in the first year.</p>
Stamps and Stationery	All stationery and postage expenses directly related to the rental property are fully deductible, e.g. log book, cashbook, diary etc.
Subscriptions	Subscriptions are only allowable where it is a necessary expense to carry on the business and is obvious and direct.
Telephone and Tolls	You may claim up to 50% of line rental for your home phone and 100% for all business related toll calls. You would need several properties to justify such a claim.
Travel and Accommodation	If your rental property is in a different location you can claim costs associated with visiting the property to carry out repairs, check on tenants etc.

To be able to substantiate these claims you need an accurate accounting/record keeping system.

Essential items are:

- Rent book
- Separate bank account dedicated solely to the rental activity
- Suitable filing system in which to keep all invoices. We suggest an Eastlight file with an alphabetical index. This should also include tenancy agreements and loan agreements.
- A simple cashbook to detail income and expense transactions
- Set up an automatic payment for rentals.

Remember all records are required to be kept for a minimum of 7 years.

ACTION: Set up a simple accounting system to record rental income and expenses and to enable easy reference to appropriate documents.

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NON-DEDUCTIBLE EXPENSES

It is important to consider not only those items that are deductible, but also those items for which a claim is prohibited.

- Agents commission on sale of property (however this is deducted from the sale price which may reduce depreciation recovered).
- Loan principal repayments
- Interest on private borrowings
- Legal fees directly associated with the purchase/sale, unless under \$10,000.
- The cost of capital improvements to the property (although they can be depreciated).
- Assets purchased in excess of \$500 (while not directly deductible, can be depreciated).

The distinction between what is repairs and what is capital improvement can be a difficult area to interpret. If in doubt we suggest you seek professional advice as there are significant penalties able to be imposed by the Inland Revenue Department if a claim is subsequently disallowed on the basis of an incorrect interpretation.

SELLING THE PROPERTY

DO NOT automatically assume that because you sold at a profit that there will be a recovery of depreciation claimed. Frequently we note it is actually the land which has increased in value while the value of the building may actually have decreased. We can advise on your options in this area.

GOODS AND SERVICES TAX

Renting out residential property is exempt from GST. This means you cannot charge GST on rental and conversely you cannot claim GST on any expenses you incur for a residential rental property. The GST inclusive values are used in the Income Statement.

Commercial rent is subject to GST

SUMMARY

While there may appear to be an overwhelming amount of complicated detail associated with the taxation treatment applicable to a residential rental property the secret to navigating the issues is good planning and a good simple accounting system.

If in doubt on any issues, seek professional advice.

Our practice is structured in such a way that we can offer landlords a cost effective service, both in general advice on purchase and ongoing issues and also in compliance with taxation requirements.

We are more than happy to discuss how we can help you to make residential rental property ownership a less taxing experience. Please contact one of our directors:

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Depreciation Categories

Chattels – the following can be depreciated for both Residential and Commercial properties

Asset Class	Estimated useful life (years)	DV rate (%)	SL rate (%)
Chattels (default class)	5	40	30
Air conditioners and heat pumps (through wall or window type)	10	20	13.5
Air ventilation systems (in roof cavity)	10	20	13.5
Alarms (burglar/smoke, wired or wireless)	6.66	30	21
Appliances (small)	4	50	40
Awnings	10	20	13.5
Bedding	3	67	67
Blinds	8	25	17.5
Carpets	8	25	17.5
Clotheslines	8	25	17.5
Crockery	3	67	67
Curtains	8	25	17.5
Cutlery	3	67	67
Dehumidifiers (portable)	4	50	40
Dishwashers	6.66	30	21
Drapes	8	25	17.5
Dryers (clothes, domestic type)	6.66	30	21
Freezers (domestic type)	8	25	17.5
Furniture (loose)	10	20	13.5
Glassware	3	67	67
Heaters (electric)	3	67	67
Heaters (gas, portable and not flued)	5	40	30
Lawn Mowers	4	50	40
Light fittings (ie, light shades/fashion items affixed to)	10	20	13.5
Linen	3	67	67
Mailboxes	15	13	8.5
Microwave ovens	4	50	40
Ovens	8	25	17.5
Refrigerators (domestic type)	8	25	17.5
Satellite receiving dishes	12.5	16	10.5
Stereos	5	40	30
Stoves	8	25	17.5
Televisions	5	40	30
Utensils (including pots and pans)	3	67	67
Vacuum cleaners (domestic type)	3	67	67
Washing machines (domestic type)	6.66	30	21
Waste disposal units (domestic type)	8	25	17.5
Water heaters (heat pump type)	10	20	13.5
Water heaters (over-sink type)	10	20	13.5
Water heaters (other eg, electric or gas hot water cylinders)	15.5	13	8.5
Water heaters (solar type)	10	20	13.5

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Fit Out – Residential Properties

Below is the IRD view on what Residential Fit Out can be depreciated

Asset Type	How to be treated	Able to be Depreciated
Plumbing and piping	Part of building	N
Electrical wiring	Part of building	N
Internal walls	Part of building	N
All doors	Part of building	N
Garage doors	Part of building	N
Fitted furniture	Part of building	N
Kitchen cupboards	Part of building	N
Bathroom fittings and furniture	Part of building	N
Linoleum	Part of building	N
Tiles (wall and floor)	Part of building	N
Wardrobes and cupboards not built into the wall	Separate asset	Y
Heating/air conditioning systems	Can be either. It depends on how the system is installed. Units which can be readily removed are likely to be separate assets.	

Those assets that the IRD deem to be part of the building will not be depreciable from the 2011/12 year on.

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Fit Out – Commercial Properties

The following can be depreciated if identified separately on the asset register.

Asset

Aerials (for televisions)
Air conditioners (split system)
Air conditioners (through-window type)
Air conditioning systems
Alarm systems
Appliances (domestic type)
Awnings
Building fit-out (default class)
Canopies
Carpets (modular nylon tile construction)
Carpets (other than modular nylon tile construction)
Ceilings (suspended)
Cleaner's cradles
Clotheslines
Cranes (overhead travelling)
Delivery systems
Dock levelers
Door closers
Doors (for strongrooms)
Doors (roller and similar)
Dry risers
Electrical reticulation
Escalators
Fences
Flagpoles
Flooring (parquet)
Floors (for computer rooms)
Fume extraction systems (ducted)
Fume extraction systems (roof mounted)
Gas dowsing systems
Generators (standby)
Grills (roller and similar)
Hand driers (air type)
Hand soap dispensers
Handrails
Heat detectors
Heating systems

Asset

Hose reels (fire)
Incinerators
Lifts
Lighting controllers (emergency)
Mailboxes
Maintenance units (for buildings)
Metal speed bumps
Meters (gas)
Meters (water)
Monitoring systems
Motors (for roller doors)
Paper towel dispensers
Partitions (demountable)
Partitions (non load bearing)
Plumbing
Plumbing fixtures
Pumps (heat)
Railings
Runway beams
Sanitary appliances
Saunas
Security systems
Signs (electric)
Signs (other than electric)
Smoke detectors
Spa pools
Sprinkler systems
Strongboxes
Toilet roll dispensers
Towel cabinets
Ventilating fans (ducted)
Ventilating fans (roof mounted)
Walkways
Walkways (moving)
Water savers
Watering systems

N.B. If fit out is not separately identified 15% of the building cost (or book value) can be allocated to fit out and depreciated at 2% cost price.

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