

RENTAL TAX GUIDE

What you need to know when buying or investing in rental property

M&H

Chartered Accountants

IF YOU'RE THINKING OF BUYING A
RENTAL PROPERTY OR INVESTING
IN MORE RENTAL PROPERTIES,
CHOOSING THE RIGHT STRUCTURE
WILL REAP THE BEST REWARDS.

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INTRODUCTION

If you're thinking of buying a rental property or investing in more rental properties, choosing the right structure will reap the best rewards.

This guide explains: the different business structures; what you can claim as expenses; how you can maximize your tax deductions; depreciation; organising your documents and how to get in touch with us. This is a general guide, but for specialist advice based on your individual needs, come and

talk to us. We will review your current tax obligations and find the best structure for your rental property business.



CHOOSING THE BEST OWNERSHIP STRUCTURE

The type of business structure you choose will affect your taxation position, your personal legal liability and the life of your business. It is important, therefore, to choose the right structure.

Whether you have an existing property, you're looking to purchase more properties or you're new to the

property market, you need to ensure that the ownership structure of your property gives you the maximum return.

The four main structures used to operate a rental business are:

- ***Sole Trader***
- ***Partnership***
- ***Company***
- ***Family Trust***

SOLE TRADER

- Manages and owns the rental property
- Easiest structure to set up
- Taxable income includes the entire taxable income of the business
- Limited ability to spread the income between family members and make tax savings
- Personally responsible for any business debt or loss
- Limited operational life of the business. When the sole trader dies, the business organization will come to an end automatically, unless stipulated in a will.



PARTNERSHIP

- Two or more people run the rental property as a business.
 - The profit or loss of the rental business may be:
 - Split evenly between the partners if there is no partnership deed. This is normally the case where there is a simple husband and wife rental business.
 - If the partnership was previously an LAQC, then the profit or loss is split in the ratio of LAQC shareholding at 31/03/2011
 - For a partnership formed after 01/04/2011 -
- A partnership deed should be established detailing the split if the partnership profits or losses are to be split unevenly between the partners, and to be enforceable, the partnership deed should last for at least three years.

COMPANY

- A legal entity that is separate from the shareholders.
- The rental property is owned as an asset of the company.
- If certain conditions are met, the company can elect to be a Look Through Company (LTC) and allocate profits and losses to the shareholders.
- LAQC structure is no longer available.

FAMILY TRUST

- Flexible means of distributing income and assets amongst various family members to provide some income tax savings.
- Each year annual accounts must be prepared, together with a tax return.
- Provides the best structure for asset protection.
- Difficult to use rental losses unless the trust has other income.

LTC vs LAQC

A major difference between an LTC and an LAQC is that an LTC passes both its profits and losses to its owners, while an LAQC only passes on its tax losses. The LTC will retain its corporate obligations and benefits under general company law, but will effectively be "Looked-through" for income tax purposes.

THE FEATURES OF AN LTC

There are two tax status options available to Companies on incorporation:

- **Standard**
- **Look Through Company (LTC)**

With the standard option, any tax losses a Company creates must be carried forward until they are used up by future profits. Capital gains can only be distributed to shareholders tax-free once the company has been liquidated.

With an LTC, any tax losses and profits made by the Company are allocated to the shareholders according to their shareholding and dividends from capital reserves (*e.g. from capital gains*) are tax-free to the shareholders.

The offsetting of losses is subject to the loss limitation rule which takes into account all shareholder loans including current accounts owed by the company to the shareholders and guarantees provided by shareholders and their associates (*this is the money at risk rule*).

Any losses that cannot be used are carried forward and may be claimed in future years, subject to loss limitation rules and/or special rules that apply if the LTC owner sells their shares or if the LTC ceases to be an LTC.

IMPORTANT FACTS ABOUT LTC's

Shareholders can elect the LTC option where they want the losses from rental property (including an allowance for chattels depreciation) to be allocated to the individual shareholders to offset against their personal income, thus resulting in a lower provisional tax liability or a refund of PAYE paid.

Both profits and losses of the LTC are allocated to the shareholders and profits, if any, will be taxed at the shareholders marginal tax rate. A breach of LTC rules will lead to a loss of LTC status and may trigger a tax event. There are also important tax issues to consider when you want to de-register the company.



***Talk to your
advisor to
find the best
tax status for
your needs.***

CHANGE OF SHAREHOLDERS IN AN LTC

As an LTC is a transparent tax entity, an LTC shareholder is treated as holding the property that the LTC owns. Therefore, if the shareholder disposes of their shares in the LTC, it will be treated as the shareholders disposing of their share of the underlying property. This may give rise to such tax implications as depreciation recovery for the shareholder disposing of shares.

However, the transfer of shares in a LTC that owns land will not create any conveyance costs since the deemed property disposal under the LTC rules only applies for tax purposes. The legal ownership of the land remains unchanged.



DEDUCTIBLE EXPENSES

Expenses that can be deducted from rental income include:

- Accounting fees
- Depreciation on chattels only
- Interest on rental property mortgage
- Legal fees involved in arranging a mortgage to acquire the rental property
- Management fees charged by property managers
- Mortgage repayment insurance
- Motor vehicle expenses related to rental activity
- Rates and insurance for rental property
- Repairs and maintenance for rental property
- Refer to pages 17-21 for a detailed list of the various items of expenditure and their tax treatment.

NOTE ABOUT GST:

Residential properties are exempt from GST. You cannot charge GST on residential rents so you cannot claim for the GST on any residential property expenses. GST is included in commercial rental property.

For more information about GST, contact your advisor.

MAXIMISING INTEREST DEDUCTION

As a general rule, no tax deduction is allowed for mortgage interest relating to your personal residence, but tax deductions are allowed for interest on rental property mortgages.

When purchasing a rental property, your loan structure must maximise interest deductions in relation to the rental property and minimise interest in relation to your personal residence.

There are some options with buying rental property in a company structure that can effectively transfer personal debt to tax deductible debt.

Please contact your advisor for more information.

CLARIFICATION BY THE IRD ON REPAIR & MAINTENANCE EXPENSES

The IRD has issued a number of interpretation statements relating to repairs and maintenance expenses. As per these statements the replacement of a toilet that has fallen in to disrepair in a residential house is likely to be deductible as repairs and maintenance.

Please contact your advisor to discuss if repairs & maintenance to be undertaken on your property is deductible as maintenance, or if it will need to be capitalised as property improvement.



ALLOCATION OF LAND, BUILDING AND CHATTEL VALUES

When acquiring a rental property, to maximise tax benefits you need to be able to allocate the price between the land, building and chattels. The most advantageous position will be to maximise the value of chattels.

METHODS FOR ALLOCATING LAND, BUILDING AND CHATTEL VALUES

Three methods are used to allocate the values:

- 1) Guesstimate by the buyer or seller**
- 2) Valuation by a land and/or chattels valuer**
- 3) Breaking down the value of the land, buildings and chattels in the sale and purchase agreement**

We recommend that an independent valuation be undertaken by a chattels valuer who will break out all the individual chattels costs from the land and building.



ADVANTAGES OF A CHATELS VALUATION

If you purchased your property for \$300,000 and your marginal rate of tax is 33%, then the advantage of a chattels valuation would be as follows:

Depreciation calculation without chattels valuation			
Assets	Cost	Depn Rate	Depreciation
Land	\$125.000	-	-
Building	\$170.000		
Chalets per sale & Purchase agreement	\$5.000	18%DV*	\$900
Total	\$300.000		\$900
Depreciation calculation with chattels valuation			
Assets	Cost	Depn Rate	Depreciation
Land	\$125.000	-	-
Building	\$125.000	-	-
Chalets per sale & Purchase agreement / Valuation	\$50.000	18%DV*	\$9000
Total	\$300.000		\$9000
Difference			\$8100
Additional tax savings (\$8100 x 33%)			\$2673
*Average depreciation of chattels			

A chattels valuation costs approximately \$400 and is well worth the investment for a tax saving (in this example) of \$2,673 for the first year. Subsequent years will obviously reduce as asset values drop.

CLAIMING DEPRECIATION

Depreciation and depreciation claw back is an issue concerning most property investors.

Depreciation claw back

The term depreciation claw back is when you claim building depreciation over time on a property, sell the property for a profit and then pay back tax on the building depreciation you have recovered. This often results in considerable tax becoming payable. This tax consequence is often forgotten when rental property owners make the decision to sell. Subsequent to the changes brought by the 2010 budget, depreciation on buildings has now been removed.

Please contact your advisor for more information.

A FLEXIBLE APPROACH

As rental property chattels decrease in value, we suggest that you take advantage of the fact that chattels depreciation can still be claimed. If structured correctly, the book value of chattels should represent the market value when the property is sold and not be subject to the depreciation claw back.



CHANGES TO THE INCOME TAX ACT 1994 & 2007

In 1997, section EG16A was added to the Income Tax Act 1994 allowing taxpayers to elect not to depreciate certain assets (i.e. chattels inside a rental property). The election is effective from the time of the acquisition of the asset. It does not permit taxpayers to 'pick and choose' the years in which they will depreciate the asset, so if you started claiming depreciation on the asset, you may not stop claiming it subsequently.

Subsequent to the changes brought by the 2010 budget, depreciation on buildings has now been removed.

However, taxpayers can still depreciate the chattels and this is a good reason to get the chattels valuation done.

For rental property buildings that were depreciated pre the 2010 budget announcement – that depreciation will be carried forward and will be “clawed back” when the property is sold with tax payable on the amount “clawed back”

RENTAL – HOLIDAY HOMES, BOATS AND PLANES

A lot has changed with regard to what can be claimed in respect of holiday homes that are both rented out and used personally (by owners/family & friends). There is also a lot more information required by your tax professional in order to complete the tax returns for those who rent out their holiday homes or charter their boats or planes

Because every situation is different we advise that you contact your advisor for their assistance in dealing with these changed rules.

CHOOSING A RESIDENTIAL TENANT

There are two ways of making money from your investment. The first is selling it for a profit and secondly, especially in a low inflationary environment, is by collecting rent from tenants who live in your property. Getting and keeping good tenants will give you an ongoing income stream from your property, providing that they are responsible, pay their rent on time and don't do any damage. The longer they stay, the better you'll be able to maximise your income and minimise your expenditure.

ADVERTISING YOUR RENTAL PROPERTY

Choose advertising that suits the type of property and location. If it's a student flat, list it with a letting agency that specialises in student letting, or with a university accommodation office, and in newspapers when the demand is highest.

Advertise in a major metropolitan daily newspaper if you're attracting tenants from outside the area. In rural areas or areas without an influx of population, advertise in a local paper or local supermarket notice board. If the property is in a busy area with high levels of passing traffic, a window sign saying 'To Let' with the owner's (or agent's) phone number can be effective. Always present the property in a clean state, with rubbish removed and tidy grounds.



THE INTERVIEW PROCESS

The ideal tenant is someone with clean habits who will look after your property as if it were their own and pay the rent on time.

When showing a prospective tenant around the property, offer an application form with an exemption from The Privacy Act so that you can check the details supplied. Check that all the prospective tenants sign the application form. If it is a group, sight all the members of the group and get all the members to sign the application form together and provide dates of birth.

CHECK THE DETAILS

Sight identification (New Zealand driver's licence, bank card, community services card, pub card, student I.D.) and check against the name(s) on the application form. Ask for copies of verifiable references, preferably from a previous landlord, or from a current employer. Telephone the referee to confirm the originality of the reference. Often people will tell you things over the phone that they would not commit to paper.

SELECTING THE TENANT(S)

You cannot discriminate on the grounds of sex, religion, ethnicity, disability or political and sexual orientation. You can decline or make conditional tenancy on the grounds of:

- Pets
- No suitable reference
- Not prepared to complete an application form or show satisfactory I.D.
- Inaccuracies in 2 & 3
- Smokers
- Number living in the property

Ask the prospective tenants how long they have lived at their present address and their reasons for wanting to shift. If they have been at their present address for a short period, or if they can give no logical reason for wanting to shift, or decline to answer, this warrants further investigation. Advise that only the successful applicant will be contacted by a certain time. If contacted by an unsuccessful applicant, do not give reasons for your decision as it may be interpreted as discrimination.



GET EVERYTHING CLEAR AT THE START

When you contact the successful tenants, arrange a time (as soon as possible) to do the paperwork. Keep all necessary paperwork together including: rental agreements, bond lodgments, refunds, transfers, change of tenant, automatic payment forms and direct debit forms.

Go through the rental agreement with the tenant(s) and explain everything clearly. Fill in the conditions: periodic or fixed term; amount of bond; period of rent payment (weekly/fortnightly); form of payment (automatic payment, direct debit, to an office or any other arrangement); amount of weekly rent in advance; the number of people allowed to live at the property and any special conditions.

If pets are allowed, specify the number, breed and name of pet and if it is to be kept outside, say so in the lease. If it is a group tenancy, get all the people who will be living at the property to sign the lease. Get the tenants' signatures, print their names, dates of birth (for I.D. and to make sure they are not minors) and next of kin (this can also be a second address for service) on the lease.

Fill out the property inspection report, chattels list (including carpets, drapes etc) and get the tenant(s) to sign for both. Don't forget appropriate bond form, automatic or direct debit form (if required) and give the tenant(s) a copy of the lease.

Remember choosing a tenant is a business decision, not an instinctive or personal one. Good people management is a large part of sound property management – treat your tenants fairly and with respect and the chances are that they will treat you and your property in the same way.

If you don't have the time or inclination to manage the tenants, then this can be done by a property management company who will charge between 7-10% of the rent.



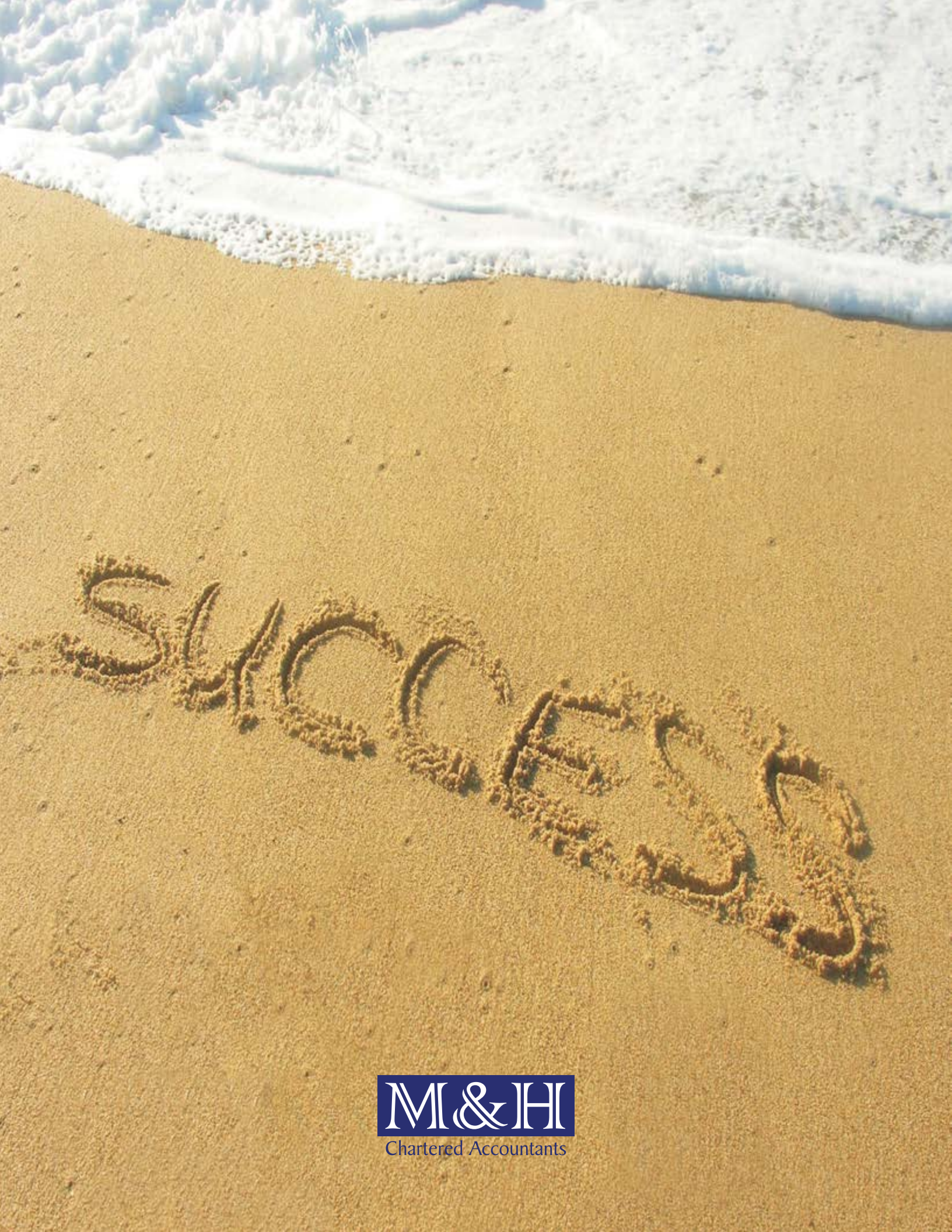
BOOKKEEPING

As with any business, good bookkeeping is essential and organising your records will help your financial advisor to claim the maximum in tax deductions for your rental business.

We recommend the following:

- 1) Set up a separate bank account for the rental property
- 2) Keep all invoices, statements, legal documents, rental agreements and loan statements together and use a separate folder for each year.
- 3) Ensure all transactions are processed through the rental property account
- 4) Reimburse any personal cash used from the rental account (this ensures that these costs will not be missed)
- 5) Log all travel to properties in a vehicle logbook.





RENTAL DEDUCTIBILITY TABLE

Expenditure	Analysis	Tax Treatment
Purchase of rental property	Split land, rental building and chattels to maximize depreciation	Land – Capitalise and do not depreciate Building – Capitalise and do not depreciate Chattels – Capitalise and depreciate (pooled 18%)
Accounting fees for setting up the business, e.g. investigating viability of business	Finance & Tax	Fully deductible expense
Legal fees incurred in arranging a mortgage to finance the rental property Legal fees for preparing a tenancy agreement Legal fees for the purchase of the property	Legal fees	Fully deductible up to \$10,000pa.
Cost of valuer to prepare valuation report	Valuation fees	Fully deductible expense.
Expenditure on a rundown property to improve it substantially and make it fit for renting out	May be treated as dilapidation expenses and therefore as part of the cost of the rental property	Capitalise and do not depreciate
Taking down a badly deteriorated wall and putting a conservatory in its place	Improvements to rental property	Capitalise as part of building and do not depreciate
Bank administration fee for the mortgage	Loan fee	Fully deductible expense
Mortgage principle payments	Reduces mortgage balance	NOT deductible
Interest on Rental property mortgage	Interest	Fully deductible expense
Rates on rental property	Rates	Fully deductible expense
Insurance on rental property	Insurance	Fully deductible expense

Expenditure	Analysis	Tax Treatment
Mortgage repayment insurance for mortgage on rental property	Insurance	Fully deductible expense
Interest on money borrowed to acquire an asset apart from the rental property, with rental property being used as security for loan	Drawings	Private expenditure, not deductible
Agent's fee to collect the rent and maintain the property Commission paid to agent to find tenants for property	Agent's fees and commission	Fully deductible expense
Replace broken shower head Plastering and painting crack in wall Replacing a blown element in a hot water cylinder Redecorating the property to return it to the state it was in when you purchased it for use as a rental property	Repairs and Maintenance	Fully deductible expense
Redecorating expenses or other maintenance, and property is therefore temporarily unavailable for letting.	Repairs and Maintenance	Fully deductible expense



Expenditure	Analysis	Tax Treatment
<p>Using your motor vehicle to carry out a property inspection</p> <p>Using your motor vehicle to do some repairs on the property</p>	Motor vehicle expenses	<p>If you use your own vehicle, you may be able to claim some vehicle running costs. There are two options for claiming your motor vehicle expenses:</p> <p>*Use the IRD for up to 5,000km of rental activity trips:</p> <p>*Claim a percentage of the running costs of your motor vehicle related to your rental activity, based on your log book:</p> <p>You will need to keep a logbook for three months every three years. Just record the business trips. You will need to record the date and reason for each trip in the logbook. You can use the difference between the odometer reading at the start and end of the three months to work out the percentage of vehicle expenses claimable.</p>
<p>Accounting fees for preparing rental income statements</p> <p>Accounting fees for preparing tax returns</p>	Finance & Tax	Fully deductible expense
Expenses incurred while property is empty. Rental property is available to be rented out.	Various expenses as detailed above	You may be required to prove the property has been advertised as available for rent. In most cases these expenses will be fully deductible.

Expenditure	Analysis	Tax Treatment
Fair and reasonable portion of the house outgoings to conduct the rental business from your home	Home office expenses	<p>If you use your home to conduct a rental business, you may be entitled to a partial deduction for the outgoings, which relate to the use of the home for business activities. These include:</p> <ul style="list-style-type: none"> • Heating • Lighting • Rates • Insurance • Mortgage Interest • House & contents insurance • Repairs & maintenance • Telephone rental <p>The portion of the outgoings deductible is based on the area used for business, expressed as a percentage of the total area of the home:</p> <p><u>Area used for business purposes</u> Total area of home</p> <p>It is not absolutely necessary to set aside a specific room for business purposes, nor is it necessary for your home to be physically changed to suit the business. However, in cases where a separate room is not set aside, it may be appropriate to apportion the outgoings based on criteria such as the amount of time spent on income-earning activities at home as well as the area used.</p>
Depreciation or allowance for wear and tear and ageing of the building contents(chattels)	Depreciation	Only allowed on chattels

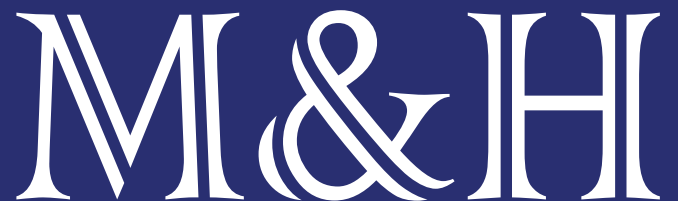
Rental Income	Analysis	Tax Treatment
Rent received in advance	Rental income	Return in the income year it is received
Amounts received as bond and passed on the Tenancy Bond Centre	Received from tenant and held in trust by Tenancy Bond Centre per rental agreement	NOT Income
Amounts received from the Tenancy Bond Centre for payment of damages and rent	Rental income	Return the income in the year it is received from the Tenancy Bond Centre



NOTES

FINAL NOTE

Always remember that it works best when you talk to your advisor before you make any decision, because once something is done, it is difficult to roll back when it comes to taxation.



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TALK TO US

If you are considering investing in rental property or would like to review your rental investments, get expert advice from Middleton Holland & Associates Ltd

To arrange a consultation call
09 415 2334 or email us
info@middletonholland.net.nz

Our full range of services can be
viewed at www.middletonholland.co.nz

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