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Accounting for Property income tax and GST

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Property tax can be complex.

The unique situation of each property transaction needs to be considered when working out any tax implication.

1. What kind of property buyer are you?

Property investor are of 3 types and each is treated differently under tax law:

1. **Property speculators** – buys a property always intending to sell it. The property is treated like "trading stock" and any profit or loss from selling the property is taxable. Speculating can be a one-off purchase and sale of a property. Speculators may also receive rental income from the property before they sell it.
2. **Dealers (also referred to as a trader)** – similar to a speculator buying properties for resale. The difference is there's an established regular pattern of buying and selling properties.
3. **Investors** – buys a property to generate ongoing rental income and not with any firm intention to resell it. The property is a capital asset and any profit or loss from selling the property is capital and not taxable (apart from clawing back any depreciation, which is now recoverable).
   The rules may be different if you've been associated with a person or entity involved in the business of building, dealing, developing or subdividing land. However, if you purchased the property on or after 1 October 2015 and sell it within two years the sale may be taxable.

The category you fall into isn't determined by:

- what the property is called or
- how the activity is described.

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It's important to note that only one of your firm intentions needs to be resale for you to be potentially classified as a speculator or dealer.

Example:

Buying a property as an "investment" with a plan of holding it for now and selling it in a few years would likely put you into the speculator or dealer category. Simply renting a property doesn't automatically exclude you from paying tax on the sale. Investors, dealers and speculators may all rent out their properties from time to time.

Four main factors can determine your status as a property buyer for tax purposes:

1. Your intention when you buy a property
2. The patterns of your previous property transactions
3. Your association to a builder, property dealer or developer
4. The bright-line test for residential property. Any purchase and sale of a property within two years may be taxable, even if it's not taxable as part of your property business. Generally not applicable to main house

2. Property speculation

1. Your family/private home

Buying and selling your family/private home usually has no tax consequences. If you buy a family home intending to resell it, and do this regularly to earn income or you have a regular pattern of buying and selling your family home, this could be seen as property dealing or speculation for tax purposes.

2. Holding onto a property for capital gain

If you buy a property with the firm intention of resale, it doesn't matter how long you hold it – the gain on resale will be taxable (and any loss may be tax-deductible). For example, you buy a property with a firm plan to resell it for a profit. The property market falls and you decide to hold onto it instead. You rent it out for 15 years and then sell it when the prices are again rising rapidly. Any gain on that sale 15 years later is likely to be taxable

3. Number of properties to be considered taxable

There's no set number of properties you can have before they become taxable. In some cases the first property bought and sold may be taxable if you bought it for resale. In other cases there could be a number of factors, such as having a regular pattern of buying and selling property, before property income is taxable. The factors looked at will vary because each taxpayer's circumstances are different. For example, buying one property every two years may be considered a regular pattern for one individual and not another.

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Switching back to property investment from speculation or dealing

Properties you bought as a dealer, builder or developer are treated like trading stock and are taxable when you sell them, regardless of any change in your status.

For example: if you buy a rental property when you're a dealer but decide to hold it and rent it during a market downturn, any later gain on the sale will still be taxable, even if you're no longer a dealer.

Depreciation

Changing from rental property investment to rental property speculation or dealing can also affect depreciation on your properties. Rental investors can claim annual depreciation on the cost price of their property buildings, fitout and furniture, but investors who hold property as trading stock can't claim annual depreciation.

Note: From the 2012 income year you can no longer claim depreciation on rental property buildings. While there's no depreciation deduction for rental properties after the 2012 income year it's important you consider and account for any historical depreciation claimed when you're selling the property. We strongly recommend you talk to us if you are in this situation.

Still can't decide?

Ask yourself, "Is the property going to give me a return on my investment, or will it only give me a positive return when I sell it at a profit?" You may receive some income from renting the property but if, from the outset your real reason for buying the property was to sell it at a profit, you're a speculator.

Some investors may find the returns from buying and selling rental properties are much higher than the actual rental income those properties can provide, so they switch from being investors to dealers. If you start dealing in rental properties, any profits on your sales from the time you become a dealer are taxable.

This probably won't affect the sale of any rental properties you owned before becoming a dealer, assuming you bought them to provide rental income, not for resale.

3. Special rules for those in property related activity

Properties sold as part of a property dealing or building business are taxable in the same way trading stock of a business is. Property dealers and builders (and those associated with them), should also take extra care when dealing with properties that weren't bought as part of their business activities if those properties are sold within 10 years. Once you're a dealer (or associated with one), special rules apply. Any profit may be taxable if you own any properties whether or not for the purpose of dealing, and:

- sell any property that is part of the assets of the activity of dealing, or
- sell any other property within 10 years of buying it. This applies to all properties you buy from the time you begin dealing to the time you cease dealing, and includes rental properties.

There are exceptions for some private residences and business premises. Rental properties don't qualify as a business for this exclusion.

These rules may apply to any properties bought during the period of your property-related business activities, even if you sell a property after you cease these business activities.

Example:

Trent started buying and selling residential houses in 2008. By the end of 2008, he had established a regular pattern of buying and selling and was a dealer for tax purposes. Trent co-owns Trent Rentals Ltd, a company that buys residential rental investment properties.

In January 2010 the company buys a rental property to hold and rent. In December 2014, rentals in the area are falling and it sells that property.

Income tax would not normally be due on the profits from the sale, because the company bought it as an investment. But, because Trent Rentals Ltd is associated with Trent, who established himself as a dealer before this property was bought and it was sold within 10 years, Trent Rentals Ltd must pay tax on the sale regardless of the company's original intention to hold it as a rental investment.

To understand the special tax rules that apply when you or an associate are dealing in property related activities, we strongly recommend you talk to a tax professional. You should get advice before selling any property you have held for less than 10 years, if it isn't part of your or your associate's business.

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4. Property transactions and associated person rules

If you have an association with people in certain property-related industries, there may be a tax impact on all or some of your property transactions, even if you're not personally a property dealer, developer or builder. These impacts could mean the difference in the gain from the sale of a property being treated as taxable income or as a non-taxable capital gain.

The associated person rules could affect you when you wouldn't have even considered such an association. So, if you're considering investing in property or selling your private residence, it's important you talk to a tax professional. Particularly if you think there is any possibility of an association applying to you.

Associated person rules may make a property sale taxable when there's an association with:

- a property dealer when the property was bought
- a property developer when the property was bought
- a builder when significant improvements started on a property.

How individuals can be associated

There are a number of tests used to work out if two persons are associated for land transactions.

Under the basic rules you are, for example, associated with:

- your spouse, civil union or de facto partner your children (under 20 years old)
- a company you hold 25% or more market interest in (company and individual test)

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- a company your spouse or children hold 25% or more market interest in (the aggregation rule)
- a company where the combined holdings under all these rules totals 25% or more market interest in (the aggregation rule)
- a partnership, if you're a partner.

If you're a trustee you're associated with:

- any settlor of the trust (and vice versa)
- a trustee of another trust where the trusts have a common settlor a person with power to appoint or remove a trustee.

Extended associations

You can be associated to a third person, where you're already associated to a second person under the above rules, and that second person is associated to the same third person under a different rule from the rule that associates you to the second person.

Example

Kim is married to Bruce, a property developer. Kim is settlor and trustee of a trust, which owns all the shares in Kim's family company. So, Bruce is associated to Kim under the two relatives test. Kim is associated to Kim's trust under the trustee and settlor test. Bruce is now also associated to Kim's trust because of his association to Kim as spouse and Kim's association to the trust as settlor.

Bruce is considered to hold what Kim's trust holds, which is 25% or more of Kim's company. So, Bruce is associated to Kim's company. Any land transactions Kim's company makes would be treated as if it were being made by a property developer (Bruce's occupation). For more information on the associated persons rules read Tax Information Bulletin Part II, Vol 21, No 8 (October/November 2009).

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5. Unplanned rental income

As a speculator or dealer, you may decide the time isn't right to sell a property, so you rent it out instead. If you do this, there are implications for income tax, and GST (if you're registered).

Income tax

You'll have to include rental income in your income tax return. You may claim costs or expenses associated with the rental.

GST

GST-registered speculators or dealers, who claim a GST refund on the property when they buy it and then rent the property to a residential tenant, need to make an adjustment in their GST return to reflect this. If you buy a property for the principal purpose of making taxable supplies (in this case, property dealing/speculation, or commercial rents), but then use it for another purpose other than making taxable supplies (e.g., residential rental), you must make a GST adjustment.

6. Living in a property owned by your look through company (LTC), company, partnership or trust

Some people buy or transfer a family home using a limited liability company, such as a look-through company (LTC) or trust or partnership, including a limited partnership.

Using an LTC for residential rental investment can be a perfectly valid structure. However, we consider some LTC arrangements are made to avoid tax. Problems arise when an LTC buys an LTC shareholder's family home, and shareholders continue to live in the home and claim deductions (e.g., interest, insurance, rates and maintenance) for the property. In most instances this is considered tax avoidance. Expenses in relation to your private residence, whether owned by you, a company in which you're a shareholder, a trust in which you're a beneficiary or a partnership you're a partner in, are not deductible. You may think that if you continue to pay market rent to the company you can continue to claim these LTC expenses against your income. However, we may still consider the arrangement to be tax avoidance.

Living with your tenants in a property owned by your LTC

The situation around tax avoidance is less clear when both a shareholder/owner and other tenants live in an LTC-owned home. The shareholder/owner's proportion of the expenses is generally not considered deductible. IRD looks at these arrangements on a case-by-case basis.

Asset protection

Some people claim the main reason for holding their personal residence in a limited liability company is for asset protection rather than to minimise tax. In reality, these structures provide little or no asset protection. For shareholders to make use of LTC losses, they must hold the shares in their own name. The market value of the shares of an LTC company that owns residential investment property is equal to the market value of the property and represents an asset to the shareholder, less the mortgage.

A creditor claim equal to the current value of the property is possible. We look closely at the reasons for such arrangements, but usually disregard the asset protection argument when considering if an LTC arrangement is tax avoidance.

If you're considering setting up an LTC to own your family/private home for tax loss claim purposes, be aware that we consider these types of arrangements to be tax avoidance.

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If you're moving into your LTC-owned property over the long-term, consider taking the home out of your LTC. If you're moving into an LTC-owned property on a temporary basis, be careful not to claim a deduction for private expenses for the period you're in the home. We strongly recommend you talk to a tax professional with expertise in this area if you're considering any of the above arrangements.

7. **GST on apartment purchases and sales**

If an apartment is being used for short-term stay accommodation (i.e., less than four weeks) the rental income may be taxable supplies for GST purposes. Many apartments are sold as "going concerns" with management leases and guaranteed rental arrangements in place at the time of purchase. No GST is paid or can be claimed on a property sold as a going concern, provided certain conditions are met, i.e., both parties are GST-registered and the management leases and rental arrangements remain in place. The transaction is defined as "zero-rated" for GST. However, the future sale will be subject to GST unless it too is zero-rated as a going concern.

Zero rating

Buying an apartment that's been zero-rated for GST may seem like a good idea because you don't have to pay GST on the purchase price. There's no hassle with tenants because the management company takes care of renting the apartment, and you may also have a guaranteed source of income. There are conditions attached to this type of transaction. You need to know what they are or you might get an unexpected GST bill.

Unexpected GST to pay

If you sell your apartment with the original or an appropriate replacement management agreement still in place, to a buyer who is also registered for GST, your apartment may still be a going concern. In this case you probably don't have to pay GST on the sale.

But, if you change the apartment use, you may have to pay GST. For example:

- if you or a member of your family move into the apartment
- if you rent it to residential rental tenants.

You may also have to pay GST if you sell your apartment and the original management agreement has expired and you haven't negotiated another lease with them. We strongly recommend you talk to us before committing to any property deal involving GST or a going concern arrangement.

8. GST claims on property

GST on property purchases

- **Buying residential rental properties to rent**
  If you buy a residential rental property as an investor you can't claim a GST credit on the purchase because renting residential accommodation is a GST-exempt activity.
- **Buying residential rental properties to trade** If you buy residential rental property as a dealer you may be able to claim a GST credit when you buy a property. You'll have to include GST in the sale price when you sell that property and pay the GST to us, unless the sale is zero-rated.

GST on property sales

If you claim a GST credit when you buy a property, you'll probably need to include GST in the sale price when you sell that property and pay the GST to us, unless the sale is zero-rated.

9. Bright-line test for residential property

From 1 October 2015 residential property sales may be taxable if you buy then sell within two years, even if you didn't intend to sell the property when you purchased it. This won't generally apply to your main home.

Purchase date for the bright-line test is the date property ownership was registered with Land information New Zealand (LINZ) until the date you sign a sale and purchase agreement to sell.

When a sale is not taxable

The sale will be taxable unless one of the following exclusions apply:

- it's your main home (see below)
- you have inherited the property
- the property has been transferred under a relationship property agreement
- the property was transferred on the death of a person to the executor or administrator of the estate.

How do I tell if the property is my main home?

You need to have lived in the property for more than 50% of the time you owned it. You must actually live in the home. Having family members using the property as their main home is not sufficient.

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What about the area of land usage?

More than 50% of the area of the land must have been actually used for the home, including such things as the yard, gardens and garages. The test is based on your actual use of the property and not your intended use of the property.

Example

Bill buys an apartment block on a single title. He lives in one of the apartments as his main home and rents out the remaining six apartments. Bill sells the apartment block to a third party. Bill can't use the main home exclusion because the land (contained on the single title) was not used predominantly as his main home. The majority of the land was used as rental property.

What if I own more than one home?

If you have two or more houses that you live in, you'll need to decide which house is your main home. This is determined by considering which of the properties you have the greatest connection with. Various factors may decide which property you have the greatest connection with, including:

- the time you occupied the home
- where your immediate family lives
- where your social ties are strongest
- your use of the home
- your employment, business interests and economic ties to the area where the home is located
- whether your personal property is in the home.

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What if my home is owned by a trust?

The Trust can use the main home exclusion if the property is the main home of a beneficiary of the Trust, but only if the settlor who contributed the most to the trust doesn't have another main home.

How many times can I use the main home exclusion?

The main home exclusion for the bright-line test can't be used if either:

- you've used the main home exclusion twice within the last two years, or
- you've engaged in a regular pattern of buying and selling of residential properties.

What if I make a loss on sale?

If your residential property sale is taxable only under the bright-line test and you make a loss on the sale you won't be able to claim the loss against your other income. The loss amount can only be claimed against any other taxable property sales net income in the same year. Otherwise you'll need to claim it in a future year when you have net income from another taxable property sale. If, however, the loss is part of property trading activity different rules apply.

Example

In October 2015 Zac sells residential property (taxable under the bright-line test). Zac purchased the land for $600,000 and sold it for $540,000, meaning he has a loss of $60,000. In the same year he had wages of $80,000. As Zac didn't have another taxable property sale in the same year he can't claim the $60,000 loss in his tax return. He needs to keep a note of this in case he can use it in a future year.

In July 2017 Zac sells land (taxable under the intention test), making a profit of $100,000. In this year's tax return Zac can use the $60,000 loss from the bright-line sale in 2017. This means he only has to pay tax on $40,000 of the profit, rather than the full $100,000.

10. Real estate agents

Income tax

You pay income tax on your net profit for the year. Commissions paid to real estate agents are schedular payments, and are taxed at a flat rate (usually 20%). Tax is worked out on the GST-exclusive amount. Tax on schedular payments is deducted on your behalf, unless you have a valid certificate of exemption.

GST

GST applies to goods and services supplied in New Zealand by GST-registered people. It's charged and accounted for at a rate of 15%.

In most cases, the agency you work for will require you to be GST-registered (because they add GST to all their invoices). If your agency doesn't require you to be GST registered, you must register if your sales (turnover) are:

• over $60,000 for the last 12 months, or

• expected to go over $60,000 for the next 12 months.

You'll also need to register if you're using buyer created tax invoices.

Note: As an agent selling on behalf of a GST-registered agency, your commission should include GST. But it doesn't always, so it's important you speak to your agency and/or tax agent first.

Expenses

Business expenses are:

• day to day expenses (revenue expenses) for the running of your business, e.g., advertising or stationery

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• assets you purchase (capital expenses) like plant or machinery, eg, vehicles.

Generally you'll claim your revenue expenses in the year that you purchase them and depreciate your capital expenses over time. If you're GST-registered your income tax return will exclude GST on your income and expenses (GST is accounted for in your GST return). If you're not GST-registered your income tax return will include GST on your expenses only.

Common expenses

Common expenses that you can claim on include:

• motor vehicles used for business purposes

• advertising, promotional material and stationery for business use

• clothing that is part of a uniform, is branded or is for health and safety purposes

• home offices that are used for business purposes.

End of year tax return

You'll need to file an IR3 individual tax return after the end of each tax year (usually 31 March). On your IR3, you'll show your total business income and expenses, as well as any other income you received during the year.

To further discuss the above, call or email us on the above address. Looking forward to assist you further!!!

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