Stephen Larsen and Co
TAX AND BUSINESS ACCOUNTANTS

Fact sheet: Rental properties ownership expenses

Income earned from rental property is taxable and you can claim deductions for costs related to earning that income. Different tax rules apply depending on the circumstances.

For tax purposes, renting to residential tenants is different from accommodation provided to short-stay guests, boarders or care home residents, or student or emergency accommodation. In addition, rental losses from residential properties may be ring-fenced, and only available for offset against income from the property or carried forward to be offset against future rental income.

The type of business structure you choose will affect your taxation position, your personal legal liability, and the life of your business so it is important to make the right choice. There are four main structures you could choose from to operate a small rental business:

- Sole trader
- Partnership
- Company
- Trust

Sole Trader

- The sole trader manages and owns the rental property.
- Taxable income includes the entire taxable income of the business and cannot be attributed to family members (eg spouses) unless by way of salary reflecting work performed.
- The sole trader is subject to the marginal individual tax rates, the highest at 39%, current from 1 April 2021.
- The sole trader is personally responsible for any business debt or loss and any business creditor will have the right to claim against the sole trader's personal assets (such as the family home) to enforce a right of payment.
- The operational life of the business is limited. When the sole trader dies, the business organisation comes to an end automatically, unless the will provides otherwise.

Partnership

- Two or more people run the rental property as a business.
- Taxable income is split between the partners. The partners pay tax at their individual rates on their partnership income.
- A partnership is not a legal entity separate from the individual partner. The members of the partnership are therefore personally liable for all partnership debts. Since partners are legal agents for each other, it is important to choose your partner or partners carefully.

Company

- A company is a legal entity separate from the people who own it (the shareholders).
- The rental property is owned as an asset by the company.
- A company is taxed separately from its owners at the corporate rate of 28%. It is important to note that the corporate rate is currently 11% lower than the highest individual marginal rate of 39%.
- Company directors have statutory obligations and various common law duties and responsibilities. All new companies are governed by the Companies Act 1993. Directors derive these powers, obligations, and duties from this Act. They must act honestly and in good faith for the benefit of all the shareholders and must exercise care, diligence, and skill in performing their

duties. If a company director breaches these duties, he or she can be fined and/or sued by a shareholder.

• In general, company directors are only liable for the company's debts to the amount outstanding of their shares, or to the amount of any personal guarantee given by them. They can however, be personally liable for the debts of the company, if the company continues to trade when it is insolvent.

• Look-Through Companies (LTCs) are companies which have a different tax treatment through an election made with Inland Revenue:

– LTC profits are directly allocated to shareholders in the same way as losses (ie profits are not required to be distributed as dividends for tax purposes), and

– LTC shareholding changes can trigger depreciation recovery (as the assets are deemed to be beneficially owned by the shareholders).

Family Trust

• A typical trust has a settlor, at least one trustee, (who has discretionary powers to distribute income and assets amongst the beneficiaries of the trust and to carry on the business) and a trust deed, the set of rules that governs the operation of the trust.

• Trusts are a popular form of business structure because they are a flexible means of distributing income and assets amongst various family members with possibly favourable tax consequences.

• The trust is taxed separately at the rate of 33%.

• Trustees are governed by the trust deed and the Trusts Act 2019. They have significant obligations to the trust beneficiaries. A trustee should be fully aware of his or her obligations before accepting any appointment as a trustee.

• It is sometimes desirable for the rental property to be owned by a family trust. However, if annual tax losses are likely, owning the property as a sole trader or utilising an LTC structure may be preferable, as the shareholders are then able to access the losses immediately (subject to the loss ring-fencing rules). A trust is not able to allocate its losses to beneficiaries, and must carry forward losses for offset against future profits.

Some of the expenses you can deduct from your rental income

• Accounting fees

• Agent's fees and commission

• Interest on the rental property mortgage, although from 1 October 2021 property owners are not able to claim interest on borrowings made for residential investment property acquired on or after 27 March 2021. Interest deductions on borrowings for residential investment property acquired before 27 March 2021 will be phased out between 1 October 2021 and 31 March 2025. Note some exemptions including for "new builds" and "build to rent" large scale developments do apply

• Legal fees for arranging a mortgage and for conveyancing to acquire the rental property

• Mortgage repayment insurance

• Motor vehicle expenses or travelling costs relating to the inspection, improvement, or repair of the property

• Rates and insurance

• Repairs and maintenance (costs over $500 which improve the building may have to be capitalised), and

• Depreciation of chattels.

Depreciation was reintroduced for commercial and industrial buildings from the 2020/21 income year. This does not include residential rentals but may apply for short-stay accommodation if it's seen as commercial. If there are four or more separate units within the same property and they're used for short-stay accommodation (such as Airbnb), deductions for depreciation may be allowable.

The rental deductibility table provides a more detailed list of various expenses and their tax treatment.

Ring-fencing of losses

The ring-fencing of residential property losses may restrict the use of rental losses to be offset against other income. We suggest you discuss this with us to determine the impact of these rules.

Goods and Services Tax (GST)

Residential properties are exempt from GST and accordingly GST is not charged on residential rents. You cannot make a claim for GST on any of your residential rental property expenses. Again, the treatment of short-stay accommodation is different. Ask us for more information on this.

Our recommendation

The right business structure can be of critical importance to the tax effectiveness of the rental business.

We suggest you discuss it with us along with your tax plan.

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