

PROPERTY PARTNERSHIP - TAX DISASTER WAITING TO HAPPEN

A client recently referred to me by an accounting colleague presented with a sad experience with the tax consequences of a partner wanting out of a jointly owned property.

The facts are as follows:

In 1997 two Auckland resident friends purchased a commercial rental property for \$135,000 and claimed GST on the purchase. As a result of the depreciation claims the partnership declared tax losses for the four year period from 1997 to 2001. These losses were split to both the partners 50/50, and offset against their other income. In 2001 one of the partners wanted out of the partnership, and transferred his interest to the remaining partner. There was a delay exceeding 2 years, before the final partnership tax return was returned. The Inland Revenue then took the following action - which by the way, was completely legal.

They stated that 'a deemed sale' had taken place when the outgoing partner sold out his interest to the remaining partner. The Revenue assessed the partnership for GST on the total 'deemed value' of the property which they maintained had a total value at the time the partnership ceased of \$175,000. This first bill was for GST on this deemed sale was \$19,500. Then came the penalties and interest estimated at approximately \$10,000. Then the tax on the depreciation recovered, plus interest and penalties totalled \$9,000. Thus the partnership has a total current liability of \$38,500.

The difficult problem which often occurs in these situations is that 'joint and several liability' for each partner exists. The result is if one partner will not, or cannot, meet their share of the tax liability, then the remaining partner can be pursued by the Revenue to pay 100% of the liability. This is precisely the situation in this example. The outgoing partner does not want to know about the problem he basically caused by removing himself from the partnership.

This serious liability incurred unexpectedly by unsuspecting partners who never had any idea that this would be the outcome. However their style of ownership going right back to 1997 was the root cause of the problem. I consider it is entirely inadequate to consider purchasing property in ones own personal name or in this example worse still in a partnership of individuals. The reasons are numerous. In addition to this 'deemed sale' example, with personal ownership, there is no asset security against the various risks faced nowadays. These risks include business and director's risk, relationship risk, and Government risk (which is the risk of being denied subsidies otherwise available). Then there is the serious tax disadvantage of having to accept being taxed at a higher rate on income you could otherwise have provided to others you are responsible for, who are on a lower tax rate. This same argument is equally valid for personal shares owned in an LAQC which owns real estate.

If I had met the client back in 1997 I could have prevented a sound structure which would have eliminated this problem and the other deficiencies of personal ownership. The moral of the story is to arrange for the best structure to be formed prior to venturing into any real estate purchase or any business.

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