

PROPERTY PARTNERSHIPS Tax disasters waiting to happen – continued. How not to have this outcome

In the recent December 2004 issue, my article provided the background to a sale by one 50% person owner of a small commercial property, to the other remaining 50% person owner. In brief, this was interpreted correctly by the Inland Revenue Department as a 'deemed sale'. The outcome of a 'deemed sale' is that for tax purposes a 'fair market value' for the property is assumed, and a complete sale is presumed to have taken place, with the new owner being the remaining partner who has effectively purchased the whole property. In this case the remaining individual owner was left with a total tax bill of \$38,500 which comprised \$19,500 GST, \$10,000 of penalties and interest and \$9,000 of tax on depreciation recovered, plus interest and penalties.

In addition to these draconian rules, an ongoing technical disadvantage to this situation is that because the original 50% owner (who is now the same individual owning 100%) is an associated party, there is no corresponding uplift in the value of the assets for depreciation. In other words, despite the sale being assessed at the theoretical higher 'fair market value' the new owner is stuck with the previous old lower asset values, to continue calculating the depreciation, and the previous applicable rates of depreciation must still be retained even although new higher rates may now be applicable for current purchases of the equivalent assets.

Readers will ask what the answer to this problem is. I always advise my clients that they need the correct and most appropriate property owning structure formed, so properties can be bought straight into this structure. There is virtually no situation where it will be relevant to purchase real estate into personal ownership. The answer is that this 'buy and hold' property should have been purchased directly into a company structure, and 50% of the shares should have been subscribed for by each of the owners' trusts. There is an option to register the company with IRD as a Loss Attributing Qualifying Company (L.A.Q.C.) to deliver 50% of the losses to each of the partner trusts. However this would not be an automatic choice in a situation where the trusts could not utilize these tax losses.

Purchasing into a structure in the first instance would have resulted in the following:

- 1) Continuity of one owner, being the company. Even if one partner sold their 50% shareholding in the future, at market value, then the sale of shares in the company would not in itself change the fact that there is one continuing company owner, and there would not be a 'deemed sale'.
- 2) The best asset security would have been obtained. The real estate value is reflected in the company's share value, which is from the outset, owned by the two separate trusts
- 3) Tax advantages would not have been lost. However, there is more tax planning involved in this type of situation.

Summary

Overall this structure would ensure that on the exit of one partner, there would be no 'deemed sale' and there would be none of the difficult outcomes experienced in the factual example.

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