

PROPERTY DEAL – WILL IT BE TAX FREE OR TAXABLE?

One of the most common questions raised by clients, friends and family is “will the property deal they outline to me be tax free, or will it be taxable”? It is to be expected that these individuals are looking for the ‘tax tips’ to give them the best tax outcome. A property deal providing profits without the 33% or 39% tax take, and without Goods and Services Tax, will be so much sweeter, and will be a big factor in the decision as to whether to proceed or reject the deal in mind.

There is a great deal of cocktail party mutterings and a huge amount of ‘urban myths’ floating around the country. Some of these misunderstandings include inaccurate statements such as, it is okay to buy and sell one rental property each year without paying tax because, an allowance enables this to happen. Therefore, if I buy and sell one each year, and if I also purchase an additional property in my wife’s name, then this will enable us to buy and sell two properties each year with profits free of tax. Also many individuals wrongly consider that by living in each of the properties for a short period that they will be absolutely safe from the revenue man; the list goes on.

How do I answer the question?

Sadly there is no simple answer; all answers must be prefaced by “it depends on the facts of the case”, and the following are some of the facts:

The tax effect for rental properties versus traded properties

The tax treatments are very different for rentals compared to trades. With rental properties (buy and holds), on purchase, it will be necessary to have a registered valuation of the property for mortgage approval, as well as a valuation of the chattels. These values will provide the starting balances for the depreciation expense (being the non cash claims). If or when the property is sold, part of the profit will be taxable and part should be tax free. The IRD will claim back part of the depreciation accumulated through tax, however, any capital gain above the original purchase price before depreciation will be free of any tax, i.e. a capital tax free profit (note relevant valuations prepared at the time of sale can sometimes mitigate the tax imposition). Providing the property is not used for commercial purposes there will be no GST implications.

The situation with trades is quite different; here the intention behind purchasing a property is to trade for profit. The real estate is merely a stock item, awaiting eventual sale. This can be likened to any stock item a trader of motor vehicles, or any other retail goods would purchase for sale to the public. The eventual profit from the sale will be fully taxed. Because the trader will be subject to GST, the business will need to be registered for GST prior to purchase of the property for the GST refund, and GST will have to be paid on the sale price.

This is the broad brush answer, but to be more specific the following comments are relevant

The purchaser's intention

This is the first test applied by the Revenue; If it was the purchaser's intention to buy a property for long term rental, rather than trade, the onus is on the individual to prove that intention by way of 'documentary evidence'. This will require copies of correspondence (which arose during the initial purchase) supporting this position, to be available on inquiry. Such documents would include correspondence with independent professionals such as the Real Estate Agent, Mortgage Broker, Structure Specialist, Lawyer, Accountant and/or Bank Manager, in which this policy needs to be stated. In other words it is completely inadequate to have intention by 'thought' alone. One must have the backup documentation in place to prove this if put on inquiry.

Subsequent events

Subsequent events are probably the second most 'telling story'. If you purchase a property with the intention to rent for the long haul, but follow this with a quick sale, then you will most likely 'mess your patch' with your stated intention. As an example, I have been advised of the recent experience suffered by an individual who purchased three properties; the original intention was to rent all three. He held these properties for just over a year, then as a result of the over heated property market, received attractive offers for all three properties, which he accepted. He was later horrified when the Revenue in their eyes, declared him a trader, taxed all the profits, plus levied him for GST being 1/9th of the sale proceeds, but denied him of the corresponding refund GST being 1/9th of the purchase price – on the basis that because he was not registered for GST at the time of purchase, he was not entitled to the refund. His actions after the purchase of the properties did not support the hypothesis that the properties were bought as rentals.

Inadvertent Tainting

There is a tax concept called 'tainting' of rental property. This can result from trading properties not being adequately isolated from rentals. In other words the tax effect from trading properties can 'leak' into the stock of rental properties. This results in tax liability on the sale of these rentals which would otherwise have provided capital tax free gains. This leakage can inadvertently be caused, for example between two companies, where one company (possibly an L.A.Q.C. registered company) owns rental properties, and a second company owns properties being traded, where individuals, such as Husband and Wife own 50% or more of the shares in both companies. This situation will generally result in the rental properties being 'tainted' and profits on the sale being taxable.

Individuals trading properties

In the heated property market, many individuals (without incorporating or forming a trust) have purchased, or intend purchasing properties with the clear intention of reselling for a quick profit, without declaring the profit. These individuals are at risk because tax or GST audits will reveal their activity. It should be noted that subdivisions in Local Body records and activities in Land Transfer Office records are available for specific or random scrutiny.

Seek Professional Advice

As has been illustrated, the whole area of tax and GST on land profits is very complex and advice should be obtained from the most experienced professionals prior to entering into any property transaction.