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Client Newsletter

LEASE INDUCEMENT PAYMENTS

When a landlord makes a payment in cash to induce a tenant into signing in to a lease, the payment is usually deductible to the landlord. Under the existing rules, a lease inducement payment received by the tenant is non-taxable. This was confirmed in a ruling by the Privy Council case in *CIR v Wattie* (1998) 18 NZTC 13,991. The Government has proposed new rules whereby the lease inducement payments will become taxable in the hands of the tenant. The new rules will be effective from 1 April 2013.

HOLIDAY HOMES

Deductibility of expenses on rental properties is quite clear but not so with properties partially used for private purposes, such as 'baches' or holiday homes. Taxpayers often want to claim partial deductions for expenses (interest being the largest) for the period holiday homes are let out.

Until recently, the Inland Revenue had allowed the property owner to claim a proportion of the expenses for the period the holiday home was carrying on a business activity provided there was a sufficient nexus between the expenses and the rental activity. This will change if the Taxation (Livestock Valuation, Assets Expenditure and Remedial Matters) Bill is legislated which has targeted deductions for mixed use assets such as holiday homes.

The Bill proposes that if a holiday home:

- is rented out on a short term basis to earn income:
- is also used privately: and
- is unused for at least two months in an income year.

Then it will be subject to the rules proposed.

Simply put, the proposed rules state that the expenses claimable will be calculated in proportion of the income earning use to the total use (i.e. private use plus income earning use). However, as they say the devil is in the detail with specific rules governing the apportionment calculation. If the Bill proposal is legislated, it will apply from the 2013-2014 income year. Watch this space in future.

Rental Investments

Investment in real estate, especially residential properties, still remains a popular choice of investment. One can see why it is attractive to New Zealander taxpayers –

- For one, there is no capital gains tax on the eventual sale of the property and land tends to appreciate with time;
- The current rate of after-tax return on fixed term deposits is low;
- Many are risk averse when it comes to share investments in the wake of the 2008 financial crisis.

However, property owners should be aware of the following regarding residential rentals:

- Repairs and maintenance expenses are only claimable if the repairs were carried out while the tenant was still living in the house or the house was still available for renting purposes. Often overseas owners returning home realise the damage done to the property after the tenants have moved out and because of the change to private use, accordingly Inland Revenue may not allow a claim for repairs to such damages.
- Splitting losses - unless the Inland Revenue is satisfied with documentary evidence to the contrary, a couple owning the property jointly cannot split rental losses unevenly. Often the higher income earning spouse claims all or most of the losses when it should be split equally.

LEASE AGREEMENTS

Over the years, leasing of assets have taken on many different names and forms – hire purchase agreements, lease to buy, operating lease, finance lease, multi-lease to name a few. Most times, the variations are used in relation to motor vehicles more than other assets.

Financing Options

Broadly speaking, there are three financing options when an asset is acquired in the course of a business:

1. Buying - purchase the asset outright from either cash available or by borrowing purchase funds from your bank;
2. Renting – the lessee agrees to pay regular (usually monthly) payments to the lessor for the use of the asset over the term of the lease. It is often referred to as an “operating lease” in the context of motor vehicles;
3. Financing – this option is by far the most common one since the purchase price of the asset is paid over the term of the lease while the asset is being used. Financing is usually provided by the lessor or a finance company simultaneous with the lease agreement

Tax Treatment

For tax purposes, substance overrides form so regardless of what the lease is called, the tax treatment of any lease agreement depends on the terms of the agreement entered into between the lessee and the lessor. These leases fall into two broad categories – operating leases and finance leases. Lease payments for operating leases are treated as expenses whereas finance lease payments are not.).

Any lease is a finance lease if one of the following applies:

- The term of the lease is greater than 75 per cent of its estimated useful life; or
- The asset is transferred to the lessee at the end of the lease term; or
- The lessee has the option to buy it at the end of the lease term.

Even when the lease is established as a finance lease, the GST treatment differs for finance leases where the ownership of the asset is transferred over to the lessee on the final lease payment. The following table sets out both, the tax and the accounting treatment of the three common types of leases available for any type of assets:

Operating Lease	Finance Lease	Lease to Buy
The term of the lease is less than 75 per cent of the useful life of the asset.	The lease term is greater than 75 per cent of the useful life of the asset.	The term of the lease can be flexible.
GST is claimed on the monthly instalments.	GST is not recoverable ‘up front’ but can be claimed on the monthly payment (net of interest).	GST can be claimed on the purchase price of the asset in the GST period in which the lease agreement begins.
The full monthly rental (net of GST) is treated as an expense.	Only the interest content of the monthly instalments is claimed as a business expense.	Only the interest content of the monthly instalments is claimed as a business expense.
No depreciation can be claimed on the asset.	Depreciation can be claimed on the cost of the asset.	Depreciation is claimed on the cost of the asset.
This has no effect on the Balance Sheet.	The asset is capitalised and the amount owing to the finance company is shown as a liability.	The asset is capitalised and the amount owing to the finance company is shown as a liability.
Legal ownership remains with the finance company at all times to the end of the lease term.	Legal ownership remains with the finance company but may pass to the lessee for a further nominal consideration at the end of the lease. Legally, this sale is a separate contract from the finance lease.	Legal ownership transfers to the lessee on repayment of the financed amount.

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